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Income Tax—Dominant Motivation Test Adopted For Business Bad Debts

The United States Supreme Court, in *United States v. Generes*,¹ has attempted to provide a suitable test for distinguishing business bad debts from nonbusiness bad debts sustained by the individual taxpayer.² The distinction is an important one for the taxpayer because of the wide divergence in the tax treatment of the two; the business bad debt receives by far the greater tax benefits.³ However, the Court has provided a test that will prove to be one of great difficulty in practice for the taxpayer.

¹405 U.S. 93 (1972).

²INT. REV. CODE OF 1954, § 166 provides in part:

(a) GENERAL RULE.—

(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

. . . .
(d) NONBUSINESS DEBTS.—

(1) General rule.—In the case of a taxpayer other than a corporation—

. . . .
(B) where any nonbusiness debt becomes worthless within the taxable year, the losses resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined.—For purposes of paragraph (1), the term “non-business debt” means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer’s trade or business.

Section 166(f), which deals with the categorization of business and nonbusiness debts in connection with the guarantor of certain noncorporate obligations, does not apply here since the obligation was clearly corporate.

Treas. Reg. § 1.166-5(b)(2) (1959) provides in part:

(2) The question whether a debt is a nonbusiness debt is a question of fact in each particular case. . . . For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt’s becoming worthless bears to the trade or business of the taxpayer. If that relation is a *proximate* one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph.

(Emphasis added.)

³A nonbusiness bad debt is treated as a short-term capital loss subject to restrictions of § 166(d)(1)(B) and §§ 1211 and 1212 of the Internal Revenue Code of 1954. Nonbusiness debts are also restricted by § 172(d)(4) of the Code for carryback purposes. Business bad debts, on the other hand, may be deducted against ordinary income; and the taxpayer is allowed to assert net operating loss carrybacks under section 172 of the Code for the unused portion of the claimed bad debt deduction. 405 U.S. at 95-96.

The test, which focuses on the "dominant motivation"⁴ of the taxpayer, calls for a complex and difficult assessment by the trier of fact—an assessment that may be set aside on review only if found clearly erroneous.⁵

The *Generes* case involves the gray middle ground of the business and nonbusiness classifications under federal tax law. *Generes* was both an employee and a shareholder in a family-owned and -operated construction business. He thus had both a business and a nonbusiness interest in the corporation. The taxpayer's status as an employee qualified his interest as a business interest, while his role as a shareholder gave him a nonbusiness interest.⁶ But the debt, for tax purposes, must be classed as either business or nonbusiness—it may not be apportioned.⁷

The taxpayer, who was president of the corporation, owned forty-four percent of its stock (on an original investment of 38,900 dollars). His employment with the business paid him 12,000 dollars a year for a work week of no more than six to eight hours. The taxpayer's work included reviewing bids and jobs, seeking and obtaining bank financing, making cost estimates, and assisting in securing bid and performance bonds. Other members of his family, including a son and two sons-in-law, owned the remainder of the stock in the corporation. *Generes*' total income averaged about 40,000 dollars a year from 1959 to 1962; some 19,000 dollars of this was received annually from a full-time position *Generes* held as president of a savings and loan association.⁸

In 1958 the taxpayer signed a personal agreement with a surety to indemnify the surety for any loss suffered by it in underwriting the corporation's contractual obligations.⁹ The construction corporation in

⁴*Id.* at 103-05.

⁵INT. REV. CODE OF 1954, § 7482(a), provides that decisions of the Tax Court shall be reviewed by the United States Court of Appeals "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury" Thus, findings of fact by the Tax Court will not be disturbed on review unless they are clearly erroneous. FED. R. CIV. P. 52(a).

⁶405 U.S. at 100-01. Since salary as an employee generates ordinary income and is taxed as such, a loss suffered by the taxpayer in protecting his salary will be allowed to offset ordinary income. On the other hand, an investor realizes capital gains on the appreciation of his investment. Due to the more favorable tax treatment allowed capital gains, as compared with ordinary income, bad debts incurred to protect an investment will correspondingly be treated as capital losses and offsets to ordinary income will be restricted under § 1211. See note 3 *supra*.

⁷405 U.S. at 96.

⁸*Id.* at 97-98.

⁹It is a common practice for shareholders of a close corporation, as here, to be required to pledge their own credit in borrowing funds. W. CARY, CASES AND MATERIALS ON CORPORATIONS 23 (1969).

1962 defaulted on two project contracts, and the taxpayer indemnified the surety to the extent of 162,104.57 dollars. The corporation went into receivership before the taxpayer was reimbursed, and the debt was not repaid. On his 1962 tax return the taxpayer claimed the loss as a business bad debt and deducted it from his ordinary income. Later he filed claims for refunds for the years 1959-1961, asserting net operating loss carrybacks under section 172 of the Internal Revenue Code of 1954 for the unused portion of the claimed bad debt deduction.¹⁰ The Internal Revenue Service disallowed the claims, and Generes brought them before a jury in a suit for refunds in federal district court. At trial the taxpayer testified that his sole motive in making the indemnity agreement was to protect his employment with the corporation. The district court charged the jury, over the government's objection, that a "significant motivation" satisfied the requirement of the regulations that a business bad debt be "proximately related to" the trade or business of the taxpayer at the time the debt becomes worthless.¹¹ Judgment for the taxpayer resulted, and the government appealed. The Fifth Circuit approved the significant motivation standard and affirmed.¹²

A writ of certiorari was granted by the Supreme Court to resolve a conflict among the circuits as to whether a significant or dominant motivation test should be applied.¹³ The Court rejected the significant motivation test adopted by both the Second and Fifth Circuits and ruled with the Seventh Circuit in adopting a test of dominant motivation for determining the proximity of the relationship between the debt and the taxpayer's trade or business. Using this test, the Court found that the debt sustained by the taxpayer Generes was a nonbusiness bad debt¹⁴ and must be treated as a short-term capital loss.¹⁵ The distinction between

¹⁰405 U.S. at 98-99.

¹¹*Id.* at 99. The Regulation is reproduced in part in note 2 *supra*.

¹²*United States v. Generes*, 427 F.2d 279 (5th Cir. 1970). See generally 3 Sw. U.L. REV. 135 (1971); 2 TEX. TECH L. REV. 318 (1971); 28 WASH. & LEE L. REV. 161 (1971).

¹³405 U.S. at 96.

¹⁴The Court ordered a judgment n.o.v. to be entered, stating:

The conclusion we have reached means that the District Court's instructions, based on a standard of significant rather than dominant motivation, are erroneous and that, at least, a new trial is required. We have examined the record, however, and find nothing that would support a jury verdict in this taxpayer's favor had the dominant motivation standard been embodied in the instructions. Judgment n.o.v. for the United States, therefore, must be ordered.

The Court dismissed the taxpayer's own testimony as self-serving. *Id.* at 106.

¹⁵*Id.* at 96.

business and nonbusiness bad debts meant a difference of over 40,000 dollars in taxes for Generes.

In his opinion for the Court, Justice Blackmun noted the difference between the business and nonbusiness interests of the taxpayer. As a shareholder Generes had a nonbusiness interest. "It was capital in nature and it was comprised initially of tax-paid dollars. Its rewards were expectative and would flow not from personal effort, but from investment earnings and appreciation."¹⁶ Generes' status as an employee was a business interest: "Its nature centered in personal effort and labor, and salary for that endeavor would be received. The salary would consist of pre-tax dollars."¹⁷

The Court cited the factors that led it to approve the dominant motive test: consistency with other sections of the Internal Revenue Code that deal with a business-nonbusiness distinction,¹⁸ consistency with the Code's objectives and with an earlier decision of the Court,¹⁹ and the superior workability of the dominant motivation standard. In attributing workability to the test, the Court noted that "[t]he trier . . . may compare the risk against the potential reward and give proper emphasis to the objective rather than to the subjective."²⁰ The Court added:

By making the dominant motivation the measure, the logical tax consequence ensues and prevents the mere presence of a business motive, however small and however insignificant, from controlling the tax result at the taxpayer's convenience. This is of particular importance in a tax system which is so largely dependent on voluntary compliance.²¹

¹⁶*Id.* at 100-01.

¹⁷*Id.* at 101.

¹⁸The Code, Justice Blackmun said, carefully distinguishes between business and nonbusiness items. In §§ 165, 162, and 166, the Code allows particular benefits for business losses, business expenses, and business bad debts, respectively. Many of these benefits are not available for nonbusiness losses, expenses, and bad debts. Justice Blackmun concluded that application of the significant motivation test to bad debts would have the effect of obliterating or blunting the meaningful distinction Congress intended between business and nonbusiness bad debts. *Id.* at 103-04. The Court also contended that the dominant motivation test strengthens and is consistent with the mandate of § 262 that "no deduction be allowed for personal, living, or family expenses' except as otherwise provided." The dominant motivation test, the Court added, "prevents personal considerations from circumventing this provision." *Id.* at 104-05.

¹⁹The Court asserted that the significant motivation test would "undermine and circumscribe" an earlier decision by the Court in *Whipple v. Commissioner*, 373 U.S. 193 (1963). The Court noted that *Whipple* emphasized that a "shareholder's mere activity in a corporation's affairs is not a trade or business." 405 U.S. at 104.

²⁰405 U.S. at 104.

²¹*Id.*

The Court summarily rejected arguments that this decision is inconsistent with the Court's approval of a significant motivation standard for liability for the accumulated earnings tax under section 531 and for inclusion in the gross estate of a transfer made in contemplation of death under section 2035.²² The Court also rejected definition of the term "proximate" in the tort sense.²³

In applying the test of dominant motivation to the *Generes* situation, the majority evaluated the taxpayer's salary and his investment in light of the surety obligation he assumed. The Court concluded that "reasonable minds could not ascribe . . . a dominant motivation . . . to the preservation of the taxpayer's salary"²⁴

Justice Douglas, in dissent, contended that the adoption of the dominant motivation test was an improper use of the Court to iron out ambiguity in the regulations. Repeating an argument he had made several times before,²⁵ Justice Douglas urged that the responsible remedy for ambiguity in the regulations or the Act was not judicial.²⁶

No test or guide is offered in section 166 of the Code for determin-

²²*Id.* at 105. The Court cited in substantiation *United States v. Donruss Co.*, 393 U.S. 297, 303 (1969), and *Farmers' Loan & Trust Co. v. Bowers*, 98 F.2d 794 (2d Cir. 1938), *cert. denied*, 396 U.S. 648 (1939). The application of a significant motivation standard in both § 531 and § 2035 favors the Government. Under *Donruss*, if tax avoidance is a significant purpose of an unreasonable accumulation of corporate earnings, then there will be a § 531 inclusion. *Bowers* provides that if a motive to avoid estate taxes played a "substantial" part in motivating pre-death transfers, then there will be inclusion in the gross estate under the "in contemplation of death" criterion of § 2035. The Court stated in *Generes* that: "Sections 531 and 2035 are Congress' answer to tax avoidance activity." 405 U.S. at 105.

²³405 U.S. at 105.

²⁴*Id.* at 107. In a concurring opinion, Justice Marshall added emphasis in the area of legislative history, concluding that the significant motivation test is wholly at odds with the goals of Congress. *Id.* at 107-12.

²⁵Justice Douglas cited as indicative his dissent in *United States v. Skelly Oil Co.*, 394 U.S. 678, 690-91 (1969).

²⁶Justice Douglas explained that the ironing out of ambiguity in the Regulations or the Act requires "either a recasting of the Regulations by Treasury or presentation of the problem to the Joint Committee on Internal Revenue Taxation which is a standing committee of the Congress that regularly rewrites the Act and is much abler than are we in forecasting revenue needs and spotting loopholes where abuses thrive." 405 U.S. at 114-15. Justice Douglas added that "[r]esort to litigation, rather than to Congress, for a change in the law is too often the temptation of government which has a larger purse and more endurance than any taxpayer." 405 U.S. at 115.

Justice Douglas also noted that *Generes'* assumption of the obligation was "proximately" related to his trade or business as the Regulations require. The bond was essential for the continued operation of the enterprise, and therefore the bond's assumption was required for *Generes* to maintain his job. "Whether it was a prudent act is not our concern. Nor is it our concern whether with the benefit of hindsight we can now say that signing the bond entailed risks wholly disproportionate to the stake *Generes* had in maintaining a job with a \$12,000 a year salary." *Id.* at 114.

ing when a bad debt is a business bad debt. However, the regulations, as previously noted, do provide that the debt must be "a proximate one in the trade or business in which the taxpayer is engaged at the time the debt becomes worthless"²⁷ in order to qualify as a business bad debt. In 1963 the Supreme Court, in *Whipple v. Commissioner*,²⁸ indicated its approval of the proximate-relation test of the regulations by refusing to recognize a debt as a business bad debt where there was "no proof (which might be difficult to furnish where a taxpayer is the sole or dominant stockholder) that the loan was necessary to keep his job *or was otherwise proximately related* to maintaining his trade or business as an employee."²⁹ The Court in *Whipple*, as the Court's opinion in *Generes* points out,³⁰ also noted the special difficulty of distinguishing between business and nonbusiness bad debts where the taxpayer is both an employee and a shareholder:

Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.³¹

Whipple has been interpreted in various ways: lower courts by turns have used it to justify the application of both the dominant and the significant motivation standards. The Second Circuit in late 1963 endorsed the test of significant motivation in *Weddle v. Commissioner*,³² in which the majority pointed out that a requirement that the business motivation be primary was simply not present in either the statute or the regulations. Looking to the law of torts, which often uses the term "proximate," the majority determined that a cause may be proximate even though it is "secondary."³³ In a concurring opinion,³⁴ Chief Judge Lumbard endorsed the primary motivation standard. He contended that the test of significant motivation would always yield a judgment for the taxpayer, and he rejected the analogy to tort law.

²⁷Treas. Reg. § 1.166-5 (1959), quoted note 2 *supra*.

²⁸373 U.S. 193 (1963); see note 19 *supra*.

²⁹373 U.S. at 204 (emphasis added).

³⁰405 U.S. at 102.

³¹373 U.S. at 202.

³²325 F.2d 849 (2d Cir. 1963).

³³*Id.* at 851.

³⁴*Id.* at 852.

Despite this attempt in *Weddle* to determine the proper test for gauging the proximity of the relationship between the debt and the taxpayer's trade or business, many of the cases decided after *Weddle* did not invoke any particular test to analyze proximity.³⁵ But in 1969, in *Niblock v. Commissioner*,³⁶ the Seventh Circuit adopted the dominant motivation standard, stating that it was the only test capable of injecting sufficient certainty into the interpretation of section 166. The *Niblock* court cited *Whipple* to substantiate its adoption of the dominant motivation standard.³⁷

The Supreme Court's endorsement in *Generes* of the Seventh Circuit's dominant motivation standard involves the federal judiciary in the complex inquiry into taxpayer motivation. The newly adopted standard, despite the statement of Justice Blackmun attributing "workability"³⁸ to it, may well prove to be more difficult to apply and may result in many inconsistent judgments. Motivation is highly elusive of effective evaluation. Men act and react for a multitude of reasons on the basis of stimuli that even they themselves often fail to recognize or appreciate fully. The more the courts are required to rely on the fact finder's assessment of the effect of these stimuli on taxpayer behavior, the more unsatisfactory become the dispositions that necessarily rely on that assessment. It is much easier to discover the presence or absence of a substantial business motivation than to determine whether a motivation is sufficiently substantial to be "dominant."

A further complication in the balancing of the motives is the definition of the key word "dominant." The Court does not define the term, and the trier of fact is left with a term that is just as ambiguous as the term "proximate" used in the regulations.³⁹ Does "dominant" mean the largest motive,⁴⁰ as for example a thirty percent motive with three

³⁵See, e.g., *Stratmore v. United States*, 420 F.2d 461 (3d Cir. 1970); *Lundgren v. Commissioner*, 376 F.2d 623 (9th Cir. 1967); *United States v. Clark*, 358 F.2d 892 (1st Cir. 1966); *Kelly v. Patterson*, 331 F.2d 753 (5th Cir. 1964).

³⁶417 F.2d 1185 (7th Cir. 1969).

³⁷*Id.* at 1187.

³⁸405 U.S. at 104.

³⁹See note 2 *supra*.

⁴⁰While there are only two categories of interest, business and nonbusiness, there are a multitude of motives that may be classified under each. It is not just the weighing of the two categories which is necessary. Were this the case the term dominant could only mean fifty-plus percent. Rather, the trier of fact is confronted in actuality with the various motives themselves, unclassified, and must proceed from there to find the dominant motivation. *Generes* leaves unanswered the question of whether the trier of fact is obligated to classify motivational forces into the two

other lesser ones of twenty-five, twenty-five, and twenty percent magnitude? Or must a motive be fifty-plus percent, dwarfing all other motives regardless of number? What if two motives—one business and one non-business—are so closely related in size as to be indistinguishable, with neither one “dominant”? The difficulty inherent in such an undertaking is obvious.

The most credible reason the Court gives for the stricter test is its fear of loopholes. But the Court's remedy for potential abuse may deny some taxpayers deductions to which they should be entitled.⁴¹ The taxpayer, as noted in *Whipple*,⁴² has the burden of establishing that the relationship to his trade or business is proximate. The dominant motivation standard as a practical matter requires him to explain away any motive that is not strictly business. As in *Generes*, the taxpayer's testimony that a nonbusiness interest did not figure in his decision will often be deemed self-serving, so the taxpayer must be able to adduce other evidence to explain his motives. In such a situation, the taxpayer's dominant motivation might in fact be a business one—to protect his job—while a jury might find his primary motivation to be the protection of his investment in the business. Numerous inconsistent judgments may result. Two separate triers of fact faced with two identical fact situations may reach opposing results because of the ambiguity of the test. A taxpayer attempting to determine in advance if his loan or assumption of debt for his corporation will later be classified as business-motivated for tax purposes will find little guidance in previous cases in which the standard has been applied.⁴³ Since a finding of dominant motivation is

categories and then reach a decision, or whether the decision may be based on the raw factors themselves unclassified. In the latter situation, with three factors or more, the trier might look to the largest of the factors rather than the larger of the two categories.

⁴¹In essence, the Court has simply made a judicial determination that in cases involving employee-shareholder bad debts, as here, the taxpayer is going to lose in the majority of the cases. This result, which is achieved by the application of the harsher dominant motivation standard, makes it easier for the Commissioner to achieve a favorable ruling in cases of this nature due to the heavier burden placed on the taxpayer. However, it is doubtful that such an approach may be justified in regard to any concept of fair and equitable taxation. Without apportionment and with the burden weighing so heavily on the taxpayer, the probable result is that taxpayers will often be denied in fact those tax benefits which are due them in theory.

⁴²373 U.S. at 202.

⁴³Advance rulings or determination letters would probably not be available due to the inherently factual nature of any determination of dominant motivation. Rev. Proc. 72-9(2), 1972-1 CUM. BULL. 28 provides in part:

It is the policy of the Service to answer inquiries of individuals and organizations, whenever appropriate in the interest of sound tax administration, as to their status for

factual, the taxpayer's opportunity to obtain reversal on appeal will be greatly diminished.

The Court's justification for adopting the dominant motivation standard pales considerably in light of the difficulty and uncertainty inherent in its application. The "workability" attributed to the new standard by the Court is not likely to materialize. The idea that the "trier . . . may compare the risk against the potential reward and give proper emphasis to the objective rather than the subjective"⁴⁴ may have merit in clear-cut situations, but it is an oversimplification in the majority of cases, which will involve closer questions.

The Court's view that the dominant motivation test makes section 166 consistent with other sections of the Tax Code is of minimal significance in view of the prospect of mass inconsistency among section 166 decisions themselves. But the significance of the *Generes* decision is much broader than its section 166 application. In *Leonard F. Cremona*,⁴⁵ a tax court case decided in the wake of *Generes*, two concurring judges suggested that the *Generes* dominant motivation test be applied to differentiate between business and nonbusiness expenses under section 162. Perhaps most important of all are the implications of *Generes* for the "business purpose" requirement of tax-free corporate reorganizations and divisions. To qualify as tax-free, these corporate realignments in addition to satisfying statutory mechanical requirements must meet judicially imposed conditions that include a requirement that there be a "business purpose" motivating the transaction.⁴⁶ A change in the character of this requirement from some business purpose to a dominant business purpose would place both the corporate taxpayer and its shareholders in a quandary similar to that of the shareholder-employee in *Generes*. The problem is intensified by the much larger

tax purposes and as to the tax effects of their acts or transactions, prior to their filing of returns or reports as required by the revenue laws.

There are, however, certain areas where, because of the inherently factual nature of the problems involved, or for other reasons, the Service will not issue advance rulings or determination letters.

The areas in which no advance rulings will be issued are enumerated in Rev. Proc. 72-9. Expansion of this list to include the determination of the dominant motivation of a shareholder-employee bad debt seems an inevitable occurrence.

⁴⁴405 U.S. at 104.

⁴⁵58 T.C. 219 (1972).

⁴⁶The "business purpose" requirement was first articulated in *Gregory v. Helvering*, 293 U.S. 465 (1935). For a discussion of the "business purpose" requirement see J. SCOTT, *FEDERAL INCOME TAXATION OF CORPORATE REORGANIZATIONS AND DIVISIONS* 97-101 (1972).

sums involved in these corporate transactions. The injection of this element of uncertainty into corporate planning would result in a severe impediment to the effective use of these tax-free corporate reorganizations and divisions.

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Labor Law—Union Discipline of Supervisor Members

Section 8(b)(1) of the National Labor Relations Act, as amended,¹ (hereinafter called the Act) provides the statutory framework within which labor unions exercise disciplinary control over their members.² The general rule, based upon *NLRB v. Allis-Chalmers Manufacturing Co.*,³ is that such discipline is a legitimate, internal union matter rarely subject to interference from the courts.⁴ A trend⁵ in the courts of appeals indicates, however, that the *Allis-Chalmers* doctrine does not apply where the disciplined member happens to be a supervisor.⁶ In two recent

¹National Labor Relations Act §§ 1-18, 29 U.S.C. §§ 151-68 (1970) [hereinafter cited as NLRA].

²NLRA § 8(b)(1), 29 U.S.C. § 158(b)(1) (1970) provides in part:

It shall be an unfair labor practice for a labor organization or its agencies—

(1) to restrain or coerce (a) employees in the exercise of the rights guaranteed in section 157 of this title: *Provided*, that this paragraph shall not impair the right of a labor organization to prescribe its own rules with respect to the acquisition or retention of membership therein

NLRA § 7, 29 U.S.C. § 157 (1970) provides in part:

Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment

³388 U.S. 175 (1967).

⁴In *Allis-Chalmers* the union had imposed fines upon employee members who had crossed picket lines and continued to work during a strike in support of new contract demands. In finding that the fines did not violate § 8(b)(1)(A), the Court concluded that "Congress did not propose any limitations with respect to the internal affairs of unions, aside from barring enforcement of a union's internal regulations to affect a member's employment status." 388 U.S. at 195.

The *Allis-Chalmers* doctrine had a slight gloss put on it in 1969. In *Scofield v. NLRB*, 394 U.S. 423 (1969), the Supreme Court added that union fines of members would not violate § 8(b)(1)(A) "unless some impairment of a statutory labor policy [could] be shown." *Id.* at 432.

⁵See text accompanying notes 31-35 *infra*.

⁶See note 18 and accompanying text *infra*, regarding supervisors as union members.