
**Corporate Integration
and
Tax-Exempt Organizations**

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I. Introduction and Scope:

- A. This outline will focus on how various schemes for corporate integration may affect tax-exempt organizations. It is assumed that all are familiar with the basic dichotomy between the current U.S. corporate tax system (i.e., the so-called "classical" or "two-tier" system) and other models which to some extent eliminate or mitigate the two-tier tax.
- B. After setting forth a few basic definitions, this outline will describe several models of corporate tax integration, and will discuss selected issues concerning the treatment of tax-exempt organizations under these models. Because the last is the most important, and because time is limited, the description of the models will be extremely sketchy.
- C. We will provide little or no comparative-law perspective. However, many foreign countries have adopted some form of integrated tax system, and the EEC has mandated this for its members.
- D. Heavy reliance is placed on a recent ALI study draft, prepared by Profs. William Andrews and Alvin Warren of the Harvard Law School: ALI FED. INCOME TAX PROJECT, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES (Memorandum No. 1, April 4, 1990) [hereinafter referred to as the "ALI Corporate Integration Memorandum"]. A few relevant pages from the ALI Corporate Integration Memorandum are attached to this outline following the bibliography.
- E. A selected bibliography is also attached to this outline at p. 10 below.
- F. Naked references to sections refer to sections of the Internal Revenue Code of 1986, as amended.

II. Definitions:

- A. An "integrated" corporate tax system differs from the "classical" system by mitigating the dual-level tax. The mitigation can take various forms, either by providing relief at the shareholder level (e.g., by exemption, a separate tax rate for distributed corporate profits, a special deduction for new equity investment, or an imputation-plus-credit mechanism) or at the corporate level (e.g., by exemption (with or without full pass-through treatment), a dividends-paid deduction, or a split-rate system). The most likely methods of integration are discussed below, at ¶ III.
- B. The pass-through system (which, in its most complete form, resembles partnership taxation) is often referred to as "full integration." (The ALI Corporate Integration Memorandum prefers to call this the "allocation" method. ALI Corporate Integration Memorandum at 32.)
- C. A dividends-paid-deduction system is often referred to as "partial integration." (The ALI Corporate Integration Memorandum prefers to call this "distribution-related" integration. ALI Corporate Integration Memorandum at 32.)
- D. A system which provides corporate shareholders with a credit measured by reference to the corporate-level tax imposed on the earnings being distributed is often referred to as an "imputation" system.

III. Selected Forms of Integration:

- A. Full integration (referred to in the ALI Corporate Integration Memorandum as "allocation" of corporate earnings to shareholders) involves direct taxation of corporate earnings to the shareholders. There are two polar models for this:

1. What might be thought of as the partnership model, under which each item of income and deduction is allocated among the shareholders, with full retention of corporate-level tax characteristics (e.g., dealer property status, passive activity status, investment interest status).
2. What might be thought of as the *old* subchapter S model (pre-1982), under which net income is computed at the corporate level and that amount is then allocated, but without preservation of corporate-level character, among the shareholders.

There is an infinite variety of intermediate models, under which some but not all of the corporate-level tax characteristics would pass through to the shareholders. Consider, e.g., the accumulation distribution throw-back rules for complex trusts (which generally pass on to the distributee-beneficiaries undifferentiated ordinary income, but which preserve the character of tax-exempt municipal bond interest, per § 667(a)), and the rules for taxing shareholders of RIC's (which generally pass on to the distributee-shareholders undifferentiated ordinary income, but which preserve the character of both capital gains, per § 852(b)(3)(B), and, under limited circumstances, tax-exempt municipal bond interest, per § 852(b)(5)).

- B. Partial integration via a deduction for dividends paid involves a corporate-level deduction for dividends. This would bring the treatment of dividends into line with the current treatment of interest. The corporate-level character of the earnings would be lost. Unlike full integra-

tion, the tax effects under this system depend on timing, since a corporate-level tax will be paid on any earnings not currently distributed.

- C. A split-rate system is like partial integration systems, except that the corporate-level relief is incomplete. Rather than a zero rate, a special rate — more than zero but less than the otherwise-applicable corporate rate — is applied to distributed corporate earnings.
- D. An imputation system, via a gross-up-and-credit mechanism quite similar to that used for the indirect (or deemed-paid) foreign tax credit, involves no corporate-level tax effects. Rather, the corporate taxes paid are taken into account, when the corporation distributes earnings, in computing the shareholder-level tax. See ALI Corporate Integration Memorandum at 38-41.
- E. A separate-rate system at the shareholder level would apply a special tax rate to distributed corporate earnings. The rate could range from zero (i.e., dividends could be exempt from tax) to any arbitrary rate, but presumably the chosen rate would always be lower than the highest rate otherwise generally applicable to individuals.
- F. A shareholder-level deduction for new equity could be permitted. (This was proposed in an earlier ALI study, ALI FED. INCOME TAX PROJECT, PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 364 (1982).) This is closely similar to applying a zero-rate shareholder-level

tax to corporate earnings distributed with respect to such new equity.¹

See ALI Corporate Integration Memorandum at 35.

- G. A corporate-level deduction for new capital investment could be permitted. This is closely similar to exempting the corporation from tax on the earnings from such investment.² It is like full integration in this respect, but differs in not attributing corporate earnings to the shareholders until actually distributed. It thus permits tax deferral. ALI Corporate Integration Memorandum at 36-38.

IV. Selected Issues Affecting Tax-Exempt Organizations:

- A. The major corporate-integration issues affecting tax-exempt organizations are set forth in ALI Corporate Integration Memorandum at 85-89. Those pages are reproduced at the end of this outline; the points contained in them are not repeated here. A few abbreviations used in those pages need to be explained:

1. "CT" stands for compensatory tax at the corporate level. Whether paid only upon distribution of income, or in advance (in which latter case it is an "ACT" or advance compensatory tax), it is imposed on income which otherwise would be exempt or under-taxed at the corporate level. By imposing a CT, the imputation

1. This is only an instance of the general rule that granting an immediate deduction for the full cost of a capital asset is equivalent to granting a tax exemption for the income produced by that asset. For a discussion, see Warren, Accelerated Capital Recovery, Debt, and Tax Arbitrage, 38 TAX LAW. 549, 551-53 (1985).

2. See note 1, supra.

system makes possible a uniform rate by which all shareholders can compute their gross-up amounts and credits.

2. "SCA" stands for shareholder credit account. This sort of account is an alternative to a CT system. Instead of making gross-up and credit rates uniform, the SCA system keeps track of actual taxes paid at the corporate level, and traces them into amounts distributed to shareholders. The gross-up and credit rates thus vary among shareholders and corporations depending on the facts and timing of distributions.
3. "RITA" stands for refundable income tax account. An example will illustrate its use: suppose the corporate tax rate is 46% and individual shareholders are to be subject to a 28% withholding tax on distributions of dividends. A corporation, earning \$100 before tax, would owe \$46 in tax. It would also increase its RITA by $21/46$ ths of all taxes paid by it, which on these facts would be \$21. Suppose the corporation distributes the remaining \$54 ($\$100 - \46) to its shareholder. The shareholder credit would be the \$21 in the RITA, so the grossed-up dividend would be \$75 ($\$54 + \21). A 28% withholding tax would amount to 28% of \$75 = \$21. That is exactly covered by the RITA. See ALI Corporate Integration Memorandum at 76.

- B. As noted above, integration systems need to cope with the proper treatment of income which, at the corporate level, is tax preferred, i.e., is taxed at a lower-than-normal corporate rate. In an imputation system, the issue becomes how to take the preferred status of the income into

account upon distribution to shareholders. (Much detail is here ignored, including choices among stacking rules.) An imputation system can address this issue in at least two fundamentally different ways: by a compensatory corporate-level tax or by a separate shareholder-by-shareholder credit account.

1. In a compensatory system, the corporation will have paid a tax even upon tax-exempt income. Unless that is refundable, tax-exempt shareholders will bear the burden of that corporate-level tax.
2. In a shareholder-credit-account system, the corporation will not have paid any tax upon tax-exempt income, and tax-exempt shareholders will not incur any upon distribution.

Thus, the latter system may be viewed as preferable because of its treatment of tax-exempt shareholders. The former, however, permits the same ultimate result (without mandating it) by making the corporate-level compensatory tax refundable. See ALI Corporate Integration Memorandum at 73-75.

- C. In an integration system, is it appropriate to retain the tax imposed on unrelated business income of tax-exempt organizations [hereinafter referred to as "UBIT"]? The question involves both major and minor aspects:
 1. The major aspects:
 - a. The fundamental policy underlying the UBIT is unfair com-

petition,³ deriving from the Congressional perception that there is unfairness in exempting some but not all competitors from entity-level taxation. If entity-level taxation is generally eliminated, via one of the corporate integration models, is there any remaining need for a UBIT?

- b. If some form of UBIT is to be preserved, how will that affect the choices among corporate integration models? It might argue for preserving at least some corporate-level income characteristics at the shareholder level, in order to distinguish between business and non-business (e.g., passive investment) activities of the distributing corporation.

2. The minor aspects:

- a. The UBIT has been used for purposes which do not relate at all to its principal policy. For example, only "exempt function income" of social clubs (and various other organizations) is tax exempt. § 512(a)(3)(A). Thus, investment income and non-member income of such entities is taxable; the Code mechanism for accomplishing this result is to

3. The legislative history and the regulations both reflect this. H. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950); Treas. Reg. § 1.513-1(b). It is beyond the scope of this outline to discuss whether the UBIT has any direct effect on competition between tax-exempt and for-profit enterprises, but the question is hardly free from doubt. See, e.g., Rose-Ackerman, Unfair Competition and Corporate Income Taxation, 34 STAN. L. REV. 1017-39 (1982); Bittker & Rahdert, The Exemption of Nonprofit Organizations from Federal Income Taxation, 85 YALE L.J. 299, 319 n. 47 (1976); Kaplan, Intercollegiate Athletics and the Unrelated Business Income Tax, 80 COLUM. L. REV. 1430, 1465-66 (1980); Klein, Income Taxation and Legal Entities, 20 U.C.L.A.L. REV. 13, 61-68 (1972).

treat such income as UBIT. Although this tax pattern makes sense, it is *not* related to the mainstream policies of the UBIT rules. As the Supreme Court recently put it:

"This distinction reflects the fact that a social club's exemption from federal income tax has a justification fundamentally different from that which underlies the grant of tax exemptions to other nonprofit entities. . . . Social clubs are exempted from tax not as a means of conferring tax *advantages*, but as a means of ensuring that the members are not subject to tax *disadvantages* as a consequence of their decision to pool their resources for the purchase of social or recreational services." Portland Golf Club v. Commissioner, ___ U.S. ___, 110 S. Ct. 2780, 65 A.F.T.R.2d 90-1162, 58 U.S.L.W. 4886, 90-1 U.S.T.C. ¶ 50,332 (1990) (emphasis in original).

In recognition of the substantially different underlying policies at work, corporate integration schemes may well treat this sort of rule differently from the mainstream UBIT rules.

- b. Another leading candidate for separate consideration is the rule subjecting unrelated debt-financed income to the UBIT provisions. § 514. Here, the issue is really base erosion, which is quite closely connected to the deepest concerns of corporate integration. Is there any reason why tax-exempt organizations should be treated differently than other recipients of base-eroding payments in a world of corporate integration?

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4.4 Exempt Shareholders and Creditors

How should tax-exempt entities be taxed on dividends under an imputation system, when those dividends may result from domestic income taxed at the corporate level, domestic preference income that was not taxed at the corporate level, or foreign taxable income subject to the foreign tax credit at the U.S. corporate level? There are several different ways to begin thinking about this question. The first would be to develop a comprehensive tax policy with regard to exempt entities that was applicable to corporate-source, as well as other, income. Such an approach seems beyond the scope of this project, at least at this preliminary stage.

A second way to begin thinking about how exempt entities ought to be taxed under imputation is to identify the major alternatives and how each would affect other features of an imputation system. That is the approach taken in this memorandum. This section pursues the interaction of shareholder exemptions with other aspects of an imputation system for domestic income. We will consider the impact of such shareholder exemptions on the available choices relating to dividends paid out of foreign income in our general discussion of international income flows in section 4.6.

The basic policy decision regarding exempt shareholders is whether imputation credits should be made refundable to such shareholders, or not. Shareholder credits in foreign imputation systems are not generally refundable to exempt shareholders. Two differentials in the tax treatment of exempt organizations under a classical system mean that achieving the policy goal of equivalent treatment of debt and equity under imputation would likely either increase or decrease the tax burden of exempt investors relative to current law.

The first differential has to do with the treatment of dividends. In a classical system, a charitable organization or pension fund that invests in corporate equities is not taxed on dividend receipts, but the income stream that produced the dividends may be taxable at the corporate level. Corporate taxable income distributed as dividends to exempt shareholders thus bear a single, corporate level tax, while corporate preference income distributed to exempt shareholders bear no taxes at all. The second differential has to do with the difference between debt and equity, because exempt holders of corporate debt instruments receive a corporate income flow that is also not taxed under current law at either the investor or the corporate level.

As a result of the current differential between debt and equity, it would not be possible to achieve exactly equivalent treatment of debt and equity under CT (or ACT) imputation without either increasing or decreasing the tax burdens of exempt organizations. Nonrefundable withholding on interest would achieve equivalence with a nonrefundable CT or ACT on dividends, but would increase exempt organizations' taxes on corporate interest payments. Fully refundable withholding would achieve equivalence with a system of refundable shareholder credits, but would reduce the current tax burden on corporate taxable income received by exempt entities as dividends.

As a result of the current differential between corporate taxable and preference income distributed as dividends to exempt shareholders, it would be difficult to achieve consistent treatment of all dividends received by exempt shareholders under a CT or ACT imputation system without either increasing or decreasing their tax burdens. If shareholder credits were refundable, the tax burden on distributed taxable income would decrease. If they were non-refundable, the tax burden on distributed preference income would increase. It might be possible to make credits refundable to exempt shareholders only on dividends paid out of corporate preference income, but the resulting accounting requirements would undoubtedly be complex.

Other non-SCA integration systems would also affect the tax burdens of exempt investors. Dividend deduction integration without withholding would reduce taxes distributed to exempt shareholders on corporate taxable income, while maintaining the non-taxability of corporate preference income so distributed. Coupling a dividend deduction with a tax on at least some dividends received by exempt shareholders would maintain a tax on corporate taxable income, while adding a tax to corporate preference income. That was the result under the dividend deduction adopted by the House of Representatives in 1985.³⁶ Coupling split rates (or dividend deduction) with a shareholder credit, as in Germany, would partially reduce the corporate tax burden on taxable income distributed to exempt shareholders and partially increase it on preference income so distributed.

A policy decision to adopt integration, but leave unchanged the tax burden on income distributed to tax-exempt shareholders, might support adoption of some version of the SCA system as in the RITA proposal and the current Australian and New Zealand systems. Corporate taxable income would bear a final corporate-level tax, while corporate preference income would pass untaxed to exempt shareholders.

36. H.R. 3838, 99th Cong., 1st Sess., section 311.

But even that result would change the position of exempt shareholders relative to other shareholders, because tax-exempts would have been denied a benefit -- credit for corporate taxes paid on taxable income -- that was extended to nonexempt shareholders.

This discussion thus indicates that every variant of imputation would necessarily affect the relative tax burden on domestic corporate income received by exempt shareholders and lenders. Put differently, if a desired effect on the tax burden on such investors is an independent policy goal, that goal may constrain the choice among imputation proposals.

Finally, if a decision were taken to deny benefits of integration to exempt shareholders, either by maintaining corporate-level taxation of taxable income, as under an SCA system, or by also increasing the tax burden on preference income received by exempt shareholders, as under a CT or ACT system, two additional questions would arise. The first is whether that effect could be achieved, given the possibility of portfolio shifts by exempt investors in response to integration. For example, if credits were only available to taxable shareholders, would exempt organizations be expected to sell shares to those who could benefit from the credits? The second question is whether it would make sense to have a

system under which an exempt shareholder would receive less in after-tax dividends than would a very low-bracket taxable shareholder, assuming the credit was refundable to taxable shareholders. The most dramatic way in which this question has been posed is: "At what rate of tax are tax-exempts tax exempt?"³⁷