# Tax Exemption for Credit Unions:
# An Unjustifiable $10 Billion Tax Expenditure

By Kenneth J. Kies and Bert Ely

***"Unlike other financial institutions like banks and thrifts, credit unions do not pay corporate taxes on their income. This puts them at a competitive advantage relative to other financial institutions for tax reasons. Eliminating this exemption would raise revenue and level the playing field."***

President Obama's Economic Recovery Advisory Board *Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation* (August 2010), p. 79.

## Summary

Credit unions have grown to control a significant share of the market for banking services, particularly in retail banking. However, unlike their direct competitors—commercial banks and thrift institutions—credit unions do not pay corporate income taxes. This huge tax expenditure—nearly ten billion dollars over the next five years, according to the Office of Management and Budget—no longer has any policy or economic justification. Credit unions have evolved to become large financial institutions which provide services that are identical to their taxpaying competitors. In order to level the competitive playing field in the banking industry, all credit unions should pay corporate income taxes.

## Evolution of Credit Unions

Today's credit unions have changed dramatically from the modest institutions with very limited missions of a century ago, when they first were exempted from federal income taxes. As initially conceived, credit unions were small, volunteer-run depository institutions serving members, many of whom had very limited means, with a common bond or affiliation, such as the same employer or church.

Today, credit unions are largely indistinguishable from banks in how, and with whom, they conduct their businesses, with one crucial exception – banks pay corporate income taxes and credit unions do not. The most recent Office of Management and Budget tax expenditure analysis estimated that the tax exemption for credit unions will reduce federal tax revenues by $9.46 billion over fiscal years 2014-2018.

Credit unions have moved sharply away from their original mission while growing substantially in size. As a consequence, they now closely resemble, and vigorously compete with, banks. This has occurred for several reasons.

First, with the consent of their regulators, many credit unions, especially the larger ones, have materially broadened their eligible membership base, or "field of membership," to include entire communities or even entire states, as in Washington, Vermont, and New Hampshire. These broad fields of membership have enabled credit unions to recruit members who are *not* of limited means, thus refuting a key justification for the credit unions' tax exemption.

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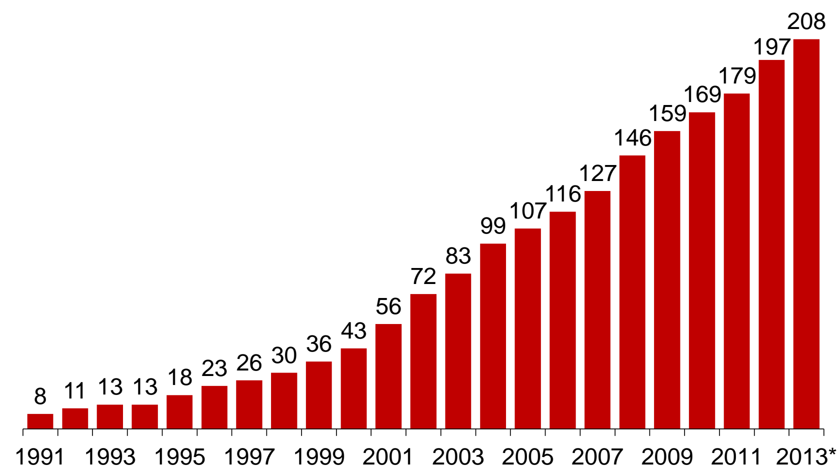
Indeed, in recent years, some credit unions have implemented schemes which permit *anyone at all* to bank with them. For example, the State Department Federal Credit Union, though formed to serve Department employees and their families, is now open to anyone, whom the credit union accomplishes by enrolling new account holders in an "advocacy" group which charges no fees and accepts all applicants as members—that advocacy group then constitutes part of the credit union's field of membership. Numerous other credit unions also offer similar unrestricted access to membership, making a farce of field of membership limitations on credit union membership.

Second, individual credit unions have grown enormously in size. This growth has been fueled both by dramatically expanded—and effectively unrestricted—fields of membership, as well as by a major consolidation among credit unions in which relatively few institutions have acquired other credit unions. Over the last twenty years, the number of credit unions has dropped by almost half, to 6,895 at March 31, 2013, even as their total assets more than quadrupled, to $1.07 trillion.

Consolidation within the credit union industry has created credit unions far larger than many of the community banks they compete against, thus providing credit unions a double advantage—they are much bigger than many of their taxpaying competitors, yet pay no federal income taxes. As of March 31, 2013, the 208 largest credit unions, each with more than $1 billion of assets, held almost 52% of total credit union assets, and were larger than 90% of the nation's community banks. An additional 223 credit unions, with total assets between $500 million and $1 billion, held another 15% of all credit union assets. The following chart shows the growth since 1991 in the number of credit unions with assets in excess of $1 billion.




These large, sophisticated credit unions use their taxpayer subsidy to compete head-to-head against banks, and vigorously market themselves to higher-income income individuals and business customers, contrary to the role initially envisioned for credit unions. In addition, especially in smaller communities, credit unions also compete aggressively against community banks.

Third, these large, complex credit unions offer essentially the same services to individuals, families, and businesses that banks do, including all types of deposit accounts and loans as well as on-line banking services. These credit unions also compete directly against banks through extensive networks of branches and ATMs. However, because credit unions do not pay corporate income taxes, they do not have to factor that expense into the pricing of their products and services, giving them an important competitive advantage over their taxpaying bank competitors.

Fourth, credit unions increasingly play down the fact that they are credit unions at all as they adopt bank-like names such as DFCU Financial, Grow Financial, Digital, and North Island Financial. Other credit unions market themselves using a nickname that masks the fact that they are a credit union: for example, Pentagon Federal Credit Union markets itself as "PenFed." The names they adopt are just one way in which credit unions work very hard to *not* differentiate themselves from banks, as is evident in their mass-media advertising.

Credit unions make much of their "non-profit" status as a rationale for not being subject to corporate income taxes. However, that rationale does not hold up to even a cursory examination. Credit unions must, and do, have very substantial earnings (i.e., total revenues minus all expenses), for that is the only way they can build the capital they must hold on their balance sheet. Banks build their capital cushion, too, by retaining a portion of their profits, but only after paying corporate income taxes on those profits.

At the end of 2012, federally insured credit unions had $74.2 billion of undivided earnings—the key component of their capital cushion. In 2012, these credit unions earned $8.5 billion in net income or profit—a record for the credit union industry—which they added to their capital buffer without paying a single penny of corporate income tax. Moreover, as the National Credit Union Administration boasted in a recent press release, "Growth [in 2012] was most robust in credit unions with assets above $250 million. This group of 751 credit unions showed the largest gains in nearly every category, including membership, net worth, market share, loans and assets."

Credit unions also argue that they should be exempt from corporate income taxes because they do not have stockholders. Instead, credit unions are owned by their members and, thus, the argument goes, they are run for the benefit of their members, not Wall Street. However, that rationale also is unfounded.

As detailed below, credit unions initially were recognized as tax exempt because of their perceived similarity to other types of mutually owned financial institutions, notably savings banks, savings-and-loans, and insurance companies. Yet the exemption for those other institutions was repealed over 60 years ago, and they have since competed successfully against stockholder-owned financial firms while paying income taxes. Credit unions will be able to compete successfully, too, after they begin paying corporate income taxes, as demonstrated by strong credit unions in Canada and Australia.

**Precedent for Repealing Exempt Status of Financial Services Entities**

The differences between banks and credit unions today are inconsequential for tax policy purposes. Banks of all sizes, as well as mutually owned savings banks and savings and loans, are subject to the federal corporate income tax. So, too, should all credit unions.

Credit unions have become so like banks, in terms of how they operate and how they market their services, that credit unions should be taxed like banks. Any basis for the credit unions' tax exemption long ago ceased to apply. As noted in a 2005 Tax Foundation study, *Competitive Advantage: A Study of the Federal Tax Exemption for Credit Unions*:

> Today credit unions continue to grow faster than banks, have little practical limitations on membership, and make business loans that increasingly have no limits on who can borrow, how much or for what purpose. Even the limits that Congress has imposed, as they otherwise removed limits on credit union markets and competition, have broad loopholes and remain under serious challenge by the credit union industry. Today the principal justification for the tax exemption would seem to be that it already exists and, therefore, removing it could adversely impact thousands of institutions and their customers.

Both Republican and Democratic Administrations have proposed repealing the tax exempt status of credit unions, thus ending a disparity which confers on credit unions an unjustified competitive advantage, at taxpayer expense.

There is ample precedent for repealing the tax exempt status of financial services entities. Among those precedents, perhaps most significant is the repeal of the tax exemption for savings and loans and cooperative and mutual savings banks. Credit unions were first characterized as tax exempt because of their similarity to those entities. Yet even though the tax exemption for S&Ls and cooperative and mutual savings banks was repealed over 60 years ago, in 1951, the tax exemption for credit unions remains.

As explained in a 2005 Government Accountability Office ("GAO") report*, Issues Regarding the Tax-Exempt Status of Credit Unions*, the Revenue Act of 1916 exempted from taxation cooperative banks without capital stock organized and operated for mutual purposes and without profit. However, credit unions were not specifically exempted in that legislation. Instead, their tax exempt status was addressed directly for the first time in 1917, when the U.S. Attorney General determined that credit unions closely resembled cooperative and mutual savings banks and similar institutions that Congress had expressly exempted from taxation.

In 1951, Congress repealed the tax exemption for cooperative and mutual savings banks as well as mutual S&Ls because those institutions were in "active competition" with taxable institutions. Congress found that they had evolved into institutions whose "investing members are becoming simply depositors, while borrowing members find dealing with a savings and loan association only technically different from dealing with other mortgage lending institutions." The GAO report further notes that, "While the [1951] act's legislative history contains extensive discussion of the reasons why the tax-exempt status of the other mutual institutions was revoked, it is silent regarding why the tax exempt status of credit unions was not also revoked." In fact, the credit union tax exemption should be repealed today for the very same reasons the tax exemptions

for similar entities were repealed decades ago—it is no longer justified by market realities and confers an unfair, taxpayer-funded advantage to certain competitors in the financial services arena.

In addition to the 1951 act, more recent legislation also has repealed the tax exempt status of certain financial services entities which were determined to compete against taxpaying businesses. Such legislation was enacted as part of the Tax Reform Act of 1986, and again as part of the Taxpayer Relief Act of 1997. Moreover, the rationales presented for the legislation which was enacted to repeal the tax exempt status of certain financial services entities—that the activities engaged in by those entities were inherently commercial and their tax exempt status conferred an unfair competitive advantage—were essentially identical to the rationales presented by the Administrations that have sought to repeal the tax exempt status of credit unions.

The last major tax reform legislation, the Tax Reform Act of 1986, repealed the tax exempt status of certain entities, such as the Blue Cross and Blue Shield organizations, which provide insurance. That provision was codified as Internal Revenue Code section 501(m).

The Joint Committee on Taxation ("JCT") *General Explanation of the Tax Reform Act of 1986* presented the rationale for section 501(m), stating:

> The Congress was concerned that exempt charitable and social welfare organizations that engage in insurance activities are engaged in an activity whose nature and scope is inherently commercial rather than charitable; hence, tax-exempt status is inappropriate. Congress believed that the tax-exempt status of organizations engaged in insurance activities provided an unfair competitive advantage to these organizations.

Initially, "grandfather" rules provided that section 501(m) did not apply to those portions of the businesses of the Teachers Insurance Annuity Association-College Retirement Equities Fund ("TIAA-CREF") and Mutual of America which were attributable to their pension businesses. However, the Taxpayer Relief Act of 1997 repealed that tax exemption for both TIAA-CREF and Mutual of America. The JCT *General Explanation of Tax Legislation Enacted in 1997* explained the reasons for repealing those exemptions:

> The Congress was concerned that the continued tax-exempt status of certain organizations that engage in insurance activities gives such organizations an unfair competitive advantage. The Congress believed that the provision of insurance at a price sufficient to cover the costs of insurance generally constitutes an activity that is commercial. Thus, the Congress believed it no longer appropriate to continue the grandfather rule that permits certain organizations to retain tax-exempt status with respect to pension business that constitutes commercial-type insurance.

In recent decades, both Republican and Democratic Administrations have proposed repealing the tax exempt status of credit unions because of the same policy concerns which prompted repeal of the tax exempt status of cooperative and mutual savings banks, the Blue Cross and Blue Shield organizations, TIAA-CREF, and Mutual of America.

**Carter Administration**. In 1978, the Carter Administration proposed that the taxation of credit unions be phased in over a four-year period. In his "Tax Reduction and Reform Message to the Congress," presented on January 20, 1978, President Carter stated:

> I am recommending changes that will recognize the contemporary practices of financial institutions and will bring the tax treatment of commercial banks, savings and loan associations and credit unions more in line with the taxation of other businesses…. Credit unions are tax-exempt. Yet, their powers and functions are defined so broadly that the term "credit union" can include financial institutions that are functionally identical to a savings and loan association. The tax exemption provides them with an unfair financial advantage over their competitors.

**Reagan Administration.** In his State of the Union address delivered on January 25, 1984, President Reagan called for the Treasury Department to conduct a study on the topic of tax reform. Accordingly, on November 27, 1984, Treasury Secretary Donald Regan presented a proposal for tax reform, which was subsequently referred to as "Treasury I". That document set out a series of tax reform recommendations to the President that did not constitute official Administration positions. Nonetheless, it comprised an integral component of the subsequent policy deliberations which ultimately led to enactment of the Tax Reform Act of 1986. On May 29, 1985, President Reagan presented his own proposal for tax reform, which became known as "Treasury II", which carried the President's imprimatur.

Both Treasury I and Treasury II proposed repealing the tax exemption for "large" credit unions, and both invoked identical policy rationales:

> Because of their tax exemption, credit unions enjoy an advantage over other financial institutions such as commercial banks and savings and loan associations….In an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions should thus be subject to tax on the same basis as other financial institutions.

**George H.W. Bush Administration.** The George H.W. Bush Administration proposed repealing the tax exempt status of credit unions with $50 million or more in assets. The Department of Treasury's "General Explanations of the Administration's Revenue Proposals", or "Green Book", describing the revenue provisions in President George H.W. Bush's FY1993 budget submission, presented this rationale for the President's proposal, stating:

> Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loan associations. Credit unions have grown rapidly since 1951, when savings and loan associations and mutual savings banks became subject to the corporate income tax. Federally insured credit unions accounted for approximately 10 percent of consumer installment credit (not including mortgages) in 1991 and their asset size approximated $200 billion.

In an economy based on free market principles, the tax system should not provide a tax subsidy to particular commercial enterprises or a competitive advantage to those enterprises over others that perform substantially the same functions. Although credit unions were founded to extend short-term personal loans to narrowly defined groups, today large credit unions frequently function more as full service consumer banks.

**Obama Administration** President Obama's Economic Recovery Advisory Board presented the policy rationale for repealing the tax exemption for credit unions in its August 2010 *Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*. The Board stated, "Unlike other financial institutions like banks and thrifts, credit unions do not pay corporate taxes on their income. This puts them at a competitive advantage relative to other financial institutions for tax reasons." The Board further noted that "Eliminating this exemption would raise revenue and level the playing field."

## Conclusion

Credit unions have moved sharply away from their original mission while growing substantially in size. As a consequence, they now closely resemble, and vigorously compete with, banks. Yet banks pay federal income taxes, while credit unions do not. This multi-billion dollar tax subsidy confers a substantial competitive advantage that no longer has any policy or economic justification. All credit unions should pay federal corporate income taxes.

September 2013