

The Changing Face of Credit Unions

Origins of the Credit Union Tax Exemption

Federal credit unions are generally exempt from all federal, state and local income or franchise taxes. State chartered credit unions are exempt from federal, and most state, income taxes.

State chartered credit unions were first exempted from the federal income tax in a 1917 administrative ruling of the U.S. Attorney General on the ground that they closely resembled the cooperative banks and similar institutions that Congress had expressly exempted from tax by legislation enacted in 1913 and 1916.¹ (It is important to note that the tax exemptions for these institutions have since been repealed.)

In 1934, Congress established federally chartered credit unions.² By 1937, some states had begun to tax federal credit unions and Congress enacted legislation to exempt federally chartered credit unions from substantially all taxes.³ Since virtually all other cooperative organizations, including mutual savings banks, mutual insurance companies and mutual savings and loans were tax exempt at that time, this congressional action simply provided consistent treatment for credit unions.

The federal credit union tax exemption has some breadth, providing that “[t]he Federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority; except that any real property and any tangible personal property of Federal credit unions shall be subject to Federal, State, Territorial and local taxation to the same extent as other similar property is taxed.”⁴

In 1951, Congress preserved the tax exempt status of state-chartered credit unions by enacting what is now section 501(c)(14)(A) of the Internal Revenue Code of 1986 (the “Code”). That exemption is available to “[c]redit unions without capital stock⁵ organized and operated for mutual purposes and without profit.”⁶ Although section 501(c)(14)(A) applies to both state and federal credit unions, federal credit unions enjoy the broader tax exemption enacted by Congress in 1937.

¹ 31 Op. Att’y Gen. 176 (1917).

² Federal Credit Union Act, Pub. L. No. 467, c. 750, 48 Stat. 1216 (Jun. 26, 1934).

³ Pub. L. No. 416, c. 3, section 4, 51 Stat. 4 (Dec. 6, 1937) (codified at 12 U.S.C. 1768).

⁴ 12 U.S.C. 1768.

⁵ According to the credit union trade press, State Employees Credit Union (NC) issued secondary capital in 2001.

⁶ I.R.C. section 501(c)(14).

The Changing Face of Credit Unions

As mentioned above, the institutions with which credit unions were identified when their tax exemption was originally granted – mutual savings banks, mutual insurance companies and mutual savings and loans – lost their tax exemptions when they reached the point of “active competition” with taxable institutions. Congressional policy has generally opposed the notion of providing tax benefits to enhance the competitive position of one group of competitors versus another group in the same marketplace. This point has clearly been reached with regard to credit unions.

Regulatory reform over the past thirty years has allowed credit unions to evolve from niche players into full-service retail depository institutions. Credit unions received federal deposit insurance in 1970, and authority to provide home loans in 1977 and share drafts (“checks”) in 1980. Moreover, since 1982 credit unions have been allowed to broaden their customer bases by adding groups that are unaffiliated with their core constituencies. As a result, credit unions have been able to grow and expand geographically, and compete head to head with banks in offering local retail banking services.⁷

Today’s credit unions behave just like other depository institutions, offering virtually the same financial services as banks, savings banks and savings and loan associations. Furthermore, credit unions can offer interest bearing business checking accounts and commercial loans⁸ including business lines of credit, agricultural loans, and venture capital loans. Credit unions also deal in sophisticated investment products including eurodollars, bankers’ acceptances, cash forward agreements and reverse repurchase transactions.

Products Offered		
<u>Products:</u>	<u>Banks</u>	<u>Credit Unions</u>
CDs	X	X
Checking	X	X
Auto Loans	X	X
Mortgages	X	X
Debit Cards	X	X
Credit Cards	X	X
Insurance	X	X

Credit unions are using their tax advantage to grow their assets. In fact, credit union assets more than tripled in size to almost \$500 billion between 1985 and 2000. During the decade of the 90s, credit unions grew at an annual rate of 7.3 percent, significantly greater than the 4.2 percent annual growth of the banking industry. Looking forward, this disparity in growth rates means that credit union assets would double over the next ten years, while it

⁷ Additionally, “federally insured credit unions operate under the same banking statutes and rules virtually identical to those applicable to banks and thrifts. Significant differences have existed in the past, but have been gradually disappearing. Recently, most of the remaining major regulatory differences between credit unions and other depository institutions were removed.” (“Comparing Credit Unions with Other Depository Institutions,” United States Department of the Treasury, January 2001.)

⁸ In general, credit union business lending is limited to a multiple of 1.75 of a credit unions capital or no more than 12.25 percent.

would take 17 years for bank assets to double. Credit union officials speculate that within the next decade credit union assets will surpass \$1 trillion.

The number of credit union members who classify a credit union as their primary financial institution rose from 28 percent in 1983 to 44 percent in 1998 (Credit Union National Association, 1998). Also, two-thirds of all credit unions aim to be the primary financial services provider to their customers (Credit Union National Association, 1999).

This expansion within the credit union industry has been concentrated among the growth-oriented credit unions. Paul Horgen, President of IBM Mid-America Employees FCU stated: "By and large, they are legitimate competitors in their markets in all objective measurements: rate, service quality, product line, delivery systems, and convenience."⁹ In 1993, these growth-oriented (over \$75 million in assets) credit unions controlled 61 percent of credit union assets. By 2000, their market share had increased to 74 percent.

Credit Union Service Organizations and Incidental Powers

Credit unions offer insurance products, securities brokerage, real estate brokerage, and other financial services through credit union service organizations (CUSOs). These activities were not permissible for credit unions. Prior to recent times, the key point was that the activities conducted in a CUSO were taxable.

But in 1999, NCUA permitted CUSOs to be organized as limited liability corporations (LLCs). Since then, almost all CUSOs have been formed as LLCs. This has provided credit unions with a new tax avoidance scheme, since the earnings of the CUSO are to be taxed at a zero percent marginally rate of their credit union owner.

Moreover, in 2001 the National Credit Union Administration (NCUA) expanded the incidental powers rule to allow credit unions to pull some of these activities back into the credit union itself, thus more directly extending the federal tax exemption to a broader range of products as well.

Since these activities, whether performed within a credit union or a credit union service organization, are not primarily related to the day-to-day operation of credit unions, the income derived from these activities should be subject to Unrelated Business Income Taxation (UBIT).

Broadly Expanded Field of Memberships

The most fundamental change in the character of credit unions has been the virtual dissolution of the common bond – the limiting factor that Congress had placed on Federal (not state) chartered credit unions. In 1998 with the enactment of the "Credit Union Membership Access Act" (CUMAA),¹⁰ Congress expanded the limits on credit union

⁹ Paul Horgen, "Awakening from the Deep Sleep: The Real Cost of Cooperation." (2002) CreditUnions.Com.

¹⁰ Pub. L. No. 105-219 section 2, 112 Stat. 913-914 (1998) (codified at 12 U.S.C. sections 1752a note and 1757a note).

membership by permitting federal credit unions to add new groups with no common bond between them, and provided little limitation on the future growth of these new groups.¹¹ Moreover, NCUA's regulatory interpretation of the law has resulted in practically no limits.

Furthermore, at the state level, regulators and legislators have, in many cases, broadened the authority of state-chartered credit unions to expand their common bonds. The significance of this action cannot be overstated – without the common bond, there is no difference between credit unions and other financial service providers.

The fundamental structure of the credit union industry is evolving. A growing number of credit unions are converting from occupational (defined by membership in a group, e.g., company employees) to community (defined by geographic areas) charters, rapidly expanding the breadth of their customer base. In the last five years, more than 500 federal credit unions have switched to community charters.

Additionally, states with more liberal field of membership requirements have seen a number of federal credit unions flip to state charters to take advantage of the broader authorities. These states with more liberal field of membership requirements include Texas, California, Missouri, Florida, and Oklahoma.

For example, Golden One Credit Union is a "community" credit union in California. Its community consists of 21 counties in the most populous and diverse state in the nation. In Texas, Credit Union of Texas, formerly Dallas Teachers CU, can serve the 2.5 million residents of Dallas and Collin Counties. In Missouri, an area code apparently constitutes a meaningful affinity when defining a community.

These are just several examples of where state authorities have effectively dispensed with any common bond requirement for membership and broadened the tax subsidy. Just because these institutions are "credit unions" in name does not mean that they meet the definition of a credit union in the Internal Revenue Code.

Conclusion

All of these developments have expanded the federal tax subsidy enjoyed by credit unions. According to estimates released by Office of Management and Budget, the forgone tax revenue will exceed \$6 billion over the next five fiscal years. The Treasury Department in its 2001 study estimates that the tax revenue loss will be \$16.2 billion between 2000 and 2009.

¹¹ CUMAA also imposed additional capital requirements on credit unions, while also subjecting these institutions to "prompt corrective action" provisions that are imposed upon the banking and thrift industries. Additionally, aggregate limits on credit union commercial lending authority were imposed for the first time, except for credit unions that primarily focus on business lending.