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Should Credit Unions Be Taxed?

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Summary

Credit unions are financial cooperatives organized by people with a common bond; they are the only depository institutions exempt from the federal corporate income tax. As financial cooperatives, credit unions only accept deposits of members and make loans only to members, other credit unions, or credit union organizations. Many Members of Congress advocate a reliance on market forces rather than tax policy to allocate resources. Furthermore, some Members of Congress are interested in additional sources of revenue in order to either reduce the deficit, offset the cost of higher federal outlays, or make up for tax cuts elsewhere. Consequently, the exemption of credit unions from federal income taxes has been questioned. If this exemption were repealed, both federally chartered and state-chartered credit unions would become liable for payment of federal corporate income taxes on their retained earnings but not on earnings distributed to depositors. For FY2008 (October 1, 2007, through September 30, 2008), the Department of the Treasury estimates that federal taxation of credit unions would yield revenues of approximately $1.48 billion. Also for FY2009 (October 1, 2008 through September 30, 2009), the Joint Committee on Taxation estimates that federal taxation of credit unions with assets of $10 million or more would yield revenue of approximately $1.80 billion.

Credit unions differ in some aspects from other providers of financial services, but financial deregulation continues to lessen these differences. Deregulation has resulted from new legislation and decisions of regulatory agencies. Proponents of the taxation of credit unions argue that deregulation has led to vigorous competition between credit unions and other depository institutions. They maintain that the tax exemption gives credit unions an unfair competitive advantage over other depository institutions, and there is no market failure that justifies government intervention with a tax subsidy. Supporters of the tax exemption claim that, despite deregulation, credit unions are still unique depository institutions. They assert that the purpose of credit unions is to serve the financial needs of their members rather than to maximize profits. They argue that taxation would eliminate this service character of credit unions.

On July 23, 2007, and December 20, 2007, the Treasury released two reports concerning U.S. business taxation and global competitiveness. In these reports the Treasury presented, for discussion purposes, a proposal to reduce corporate tax rates and broaden the corporate tax base by eliminating specific business tax preferences, including the tax exemption of credit unions. Nevertheless, in the 110th Congress, as of January 28, 2008, no legislation concerning the tax exempt status of credit unions had been introduced.

In the future, technological change and deregulation will likely further increase competition between credit unions and other depository institutions. The income tax exemption for credit unions, therefore, likely will be the subject of further debate.

This report will be updated in the event of significant legislative activity or policy proposals.

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Credit unions are the only depository institutions exempt from the federal income tax.[1] Deregulation is reducing the unique character of credit unions. Many Members of Congress advocate a reliance on market forces rather than tax policy to allocate resources. Furthermore, some Members of Congress are interested in additional sources of revenue in order to either reduce the deficit, or offset the cost of either higher federal outlays or other tax cuts. Consequently, the exemption of credit unions from federal income taxes has been questioned. If this exemption were repealed, both federally chartered and state-chartered credit unions would become liable for payment of federal corporate income taxes on their retained earnings but not on earnings distributed to depositors. For FY2008 (October 1, 2007 through September 30, 2008), the Department of the Treasury estimates that federal taxation of all credit unions would raise approximately $1.48 billion.[2] Also for FY2009 (October 1, 2008 through September 30, 2009), the Joint Committee on Taxation estimates that taxing only credit unions with assets above $10 million would yield approximately $1.80 billion.[3] Approximately one-half of credit unions have assets of $10 million or less, but these credit unions hold only about 3% of all assets in the credit union industry.[4] The issue of taxation of credit unions is examined in this report by covering the following eight topics: concept of a credit union, tax status, deregulation, arguments for and against taxation, debate in the 108th Congress, debate in the 109th Congress, debate in the 110th Congress, and trends.

Concept of a Credit Union

A credit union is a nonprofit financial cooperative organized by people with a common bond. As financial cooperatives, credit unions only accept deposits of members and make loans only to members, other credit unions, and credit union organizations.[5] A common bond is a unifying characteristic among members that distinguishes them from the general public. Every member of a credit union is an owner and may vote for credit union officers and policies. Credit unions do not have separate capital stock; instead their capital consists of their members' shares in accumulated reserves.[6] Credit unions cannot raise capital by issuing stock but utilize retained earnings to finance expansion. Credit unions are either federally chartered or state-chartered. Each credit union is governed by a board of directors. The board exercises general supervision over all functional areas including membership and credit applications, interest rate policies, and records.[7] According to the Garn-St. Germain Depository Institutions Act of 1982,

> The management of a Federal credit Union shall be by a board of directors, a supervisory committee, and where the bylaws so provide, a credit committee.
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> The supervisory committee shall be appointed by the board of directors....

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[1] All credit unions collect federal payroll taxes. Federally-chartered and state-chartered credit unions are subject to local property taxes. State chartered-credit unions may be subject to additional state and local taxes.

[2] U.S. Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2008*. (Washington: GPO, 2007), p. 287.

[3] U.S. Congressional Budget Office, *Budget Options,* (Washington: GPO, Feb. 2007), p. 294.

[4] Ibid.

[5] Richard P. Kessler, Jr. "Credit Unions in the 1990s," *Consumer Finance Law*, vol. 47, no. 1, winter 1993, p. 4.

[6] Ibid.

[7] Olin S. Pugh and F. Jerry Ingram, *Credit Unions: A Movement Becomes an Industry* (Reston, Virginia, Reston Publishing Company, Inc., 1984), p. 7.

> At their first meeting after the annual meeting of the members, the directors shall elect from their number the board officers specified in the bylaws.[8]

For June 2007, the 8,504 credit unions had 89.6 million members and total assets of $764.4 billion.[9] Thus credit unions had an average of $89.9 million in assets. Although most credit unions are small, some are large. For year end 2005, the 100 largest credit unions had assets of $1,043 million or more.[10]

Among depository financial institutions, the concept of a common bond is unique to credit unions. In 1970, the National Credit Union Administration (NCUA) was established by the federal government to regulate the credit union industry. The NCUA has specified four categories of common bonds: single occupational, single associational, multiple common bond, and community. Credit union members in the *single occupational* category are employed by the same enterprise, such as the ABC corporation. A credit union in this category may also serve a trade, industry, or profession, such as all teachers. Members of a *single associational* category belong to groups of individuals who participate in activities that develop common loyalties, mutual benefits, and mutual interests, such as the Knights of Columbus. A single associational group must sponsor activities providing for contact among members. A credit union with a *multiple common bond* consists of a combination of occupational and/or associational groups. Members in the *community* category have a common bond based on employment or residence in a geographic area with clearly defined boundaries.[11]

In the late 1970s and early 1980s, serious economic dislocations threatened the financial stability of many federal credit unions.[12] Hence, beginning in 1982, the National Credit Union Administration made a series of administrative rulings that allowed multiple-group federal credit unions; that is, combinations of existing federal credit unions that do not share a common bond.

In 1990, the American Bankers Association and several small North Carolina banks filed a lawsuit challenging the NCUA's approval of a multiple-group field of membership expansion for federal credit unions. On February 25, 1997, the United States Supreme Court, at the urging of the Clinton Administration, agreed to hear arguments in the case.

On February 25, 1998, the U.S. Supreme Court ruled in favor of the banking industry. Legislation was introduced to address the concerns of the credit union industry. On August 7, 1998, the Credit Union Membership Access Act (P.L. 105-219) was enacted. The act grandfathered all current federal credit unions (FCUs) and all current credit union members and provided for future multiple-group formations subject to limitations that the NCUA must consider when authorizing charters.[13]

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[8] P.L. 97-320, Sec. 111 and 112.

[9] Credit Union National Association, *Monthly Credit Union Estimates*, June 2007, p. 5, available from http://advice.cuna.org/download/mcue.pdf, visited Aug. 31, 2007.

[10] Credit Union National Association, *Top 100 Credit Unions, Year-End 2005*, pp. 8-9, available from http://advice.cuna.org/.

[11] National Credit Union Administration, *Chartering and Field of Membership Manual* (Washington, March 2003), pp. 18-19.

[12] The U.S. Government provided no financial assistance to the credit union industry. In contrast, the cleanup costs of the thrift industry in the 1980s and early 1990s was $124 billion according to Federal Deposit Insurance Corporation (FDIC).

[13] CRS Report 98-933, *Credit Union Membership Access Act: Background and Issues*, by Pauline Smale, p. 1. This (continued...)

On March 15, 2007, the Credit Union Regulatory Improvements Act of 2007 (CURIA) was introduced as H.R. 1537. This act would modernize capital requirements, raise the cap on member business lending, enhance the ability of credit unions to serve financially underserved areas, and provide regulatory relief.[14] As of January 15, 2008, this act had 141 cosponsors.

Tax Status

The first credit union in the United States was state chartered in 1909. When the federal income tax was enacted, state chartered credit unions were not specifically exempt. In 1917 an administrative ruling by the U.S. Attorney General exempted state chartered credit unions from federal income taxation.[15] In 1934, Congress passed the Federal Credit Union Act, which authorized the chartering of federal credit unions. This act contained no federal tax exemption and allowed states to tax federal credit unions in the same manner as banks. In 1937, Congress amended the act to exempt federal credit unions from both federal and state income taxes because of their service to members.[16] Until 1951, all savings and loans (S&Ls) were exempt from federal income taxes under the same tax code provision. The Revenue Act of 1951 repealed the tax exemption for S&Ls, but the exemption for federal and state credit unions was continued under a separate tax code provision.[17] But Congress provided S&Ls a *de facto* exemption from federal income taxes by permitting a liberal allowance for bad debt reserves. This *de facto* exemption continued until the Revenue Act of 1962, which reduced the liberal allowance for bad debt reserves.[18]

Federally chartered credit unions are exempt from all taxes (including income taxes) imposed by any state, territorial, or local taxing authority, except for local real or personal property taxes.[19] States vary in their tax treatment of state-chartered credit unions. A few states exempt state-chartered credit unions from their state income taxes. Many states tax state-chartered credit unions the same as state-chartered thrifts, and several states tax state-chartered credit unions the same as any other business.[20]

Before the passage of the Tax Reform Act of 1986, numerous specific tax preferences were given to depository institutions (except credit unions, which were and are exempt). The primary justification for these tax preferences was the extensive regulations imposed on depository institutions. These tax preferences reduced the effective tax rate on operations of depository institutions below the effective tax rate on operations of average U.S. corporate businesses.

(...continued)

report is available on request from the author.

[14] For an explanation of the contents of this legislation, see CRS Report RS22661, *Credit Union Regulatory Improvements Act of 2007 (CURIA)*, by Pauline Smale.

[15] U.S. Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions* (Washington, Jan. 15, 2001), p. 28.

[16] "The Tax Exemption Through the Ages," *Credit Union*, Jan. 1986, p. 9.

[17] U.S. Congress, Joint Committee on Taxation, (Prepared for use of the Committee on Ways and Means and the Committee on Finance), *Tax Reform Proposals: Taxation of Financial Institutions* (Washington: GPO, 1985), p. 43.

[18] Kenneth R. Biederman and John A. Tuccillo, *Taxation and Regulation of the Savings and Loan Industry* (Lexington, MA: Lexington Books, 1976), p. 5.

[19] National Credit Union Administration, *Letter of Exemption*, Alexandria, Va., revised May 2003.

[20] Pugh, pp. 51-52.

Proponents of the Tax Reform Act of 1986 contended that the tax system should be neutral concerning economic decision making. They believed that the market forces of supply and demand could more efficiently allocate resources than the tax system; consequently, tax preferences for specific industries or sectors should be eliminated or curtailed. They argued that the elimination or reduction of tax preferences would broaden the tax base and permit lower marginal tax rates; therefore, economic resources would be allocated more efficiently. Financial deregulation had been reducing both the differences among depository institutions and between depository institutions and other industries. Thus, tax preferences for depository institutions were more difficult to justify if the tax system is to be more neutral and resources are to be allocated by market forces rather than federal regulations. Consequently, the Tax Reform Act of 1986 curtailed or eliminated tax preferences of depository institutions. The three most important of these tax preferences were deductions for additions to bad debt reserves, the deduction for interest to carry tax exempt obligations, and special rules for net operating losses. The more neutral federal tax system heightened criticism of the tax exemption of credit unions.

How does credit union taxation compare with that of other firms in economic terms? For a typical corporation, income taxes are paid on income from equity-financed investment whether retained or paid in dividends. Shareholders (equity owners) pay individual income taxes on dividends and capital gains taxes on the nominal appreciation (if any) in the value of their stock in the year that the stock is sold. Income from debt financed investment is tax exempt at the corporate level; interest paid on bonds is a deductible expense to the corporation but taxable income to bondholders. Most corporate equity investment is thus taxed twice, debt once.

Commercial banks and thrift institutions are taxed like other corporations except for the tax treatment of depositors. In compensation for their deposits, depositors receive a mix of interest payments and free or below cost services. Interest payments received by depositors are subject to the individual income tax. Free or below cost services are not subject to the individual income tax, but the cost of providing these services are expenses to the commercial bank or thrift. Since it is not administratively feasible to allocate the reduced cost of financial services among depositors, it is not possible to levy income taxes on these services.[21] Thus, at least part of banks' income from debt is exempt from both corporate and individual tax. Bank equity income is taxed twice; debt once, at the most.

Income of credit unions is exempt at the corporate level, whether retained or distributed. And as with banks, a portion of the income distributed to members in compensation for their deposits, called member "dividends," is subject to individual income tax, while the portion distributed as enhanced member services is not taxed. Thus, in contrast to corporations—including corporate banks—no credit union income is taxed twice; credit union income is taxed once, at the most, under the individual income tax. Taxing credit unions in a manner similar to corporate banks would require, at least, applying corporate tax to retained credit union earnings.[22]

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[21] Most developed nations with value-added taxes exclude financial services from taxation because it is not administratively practicable to measure value-added received by customers.

[22] In theory, it might be argued that since members are also equity owners of credit unions, a portion of income and benefits accruing to stockholders is actually distributed credit union equity-like earnings, and simply taxing retained earnings would apply tax to only a part of income from equity-like investment. However, it is not administratively feasible to assess the value of these distributed equity-like benefits, and proposals to tax credit unions have been limited to applying the corporate income tax to retained earnings.

Finally, this discussion of financial institutions has thus far omitted the tax treatment of another type of financial intermediary: life insurance companies.[23] Life insurance companies receive special treatment under the corporate income tax; they are subject to a low level of tax compared to other financial intermediaries (excepting, of course, credit unions). Further, the earnings of depositors (i.e., policyholders) are lightly taxed under the individual income tax because the inside buildup—growth of cash values—on insurance policies is not subject to tax.

Deregulation

Over the past 30 years, most of the distinctions between credit unions and other depository institutions have been eliminated or reduced because of deregulation; consequently, the justification for the tax exemption for credit unions has been increasingly questioned.

Proponents of deregulation argue that resources can usually be more efficiently allocated by market forces than government regulations. They do not advocate the elimination of all regulations but rather a greater reliance on market forces. Proponents maintain that deregulation increases competition, which benefits customers through better access to services at lower prices. Furthermore, deregulation leads to more integrated financial markets, which improves national economic efficiency. Both federally-chartered and state-chartered credit unions have been deregulated as discussed in the following section. The discretionary powers of state-chartered credit unions compared with those of federally-chartered credit unions vary among states.

Deregulation can be divided into price, geographic, and product deregulation. *Price deregulation* concerns the loosening or elimination of restrictions on interest rates that depository institutions may pay on supplies of funds and charge on loans. Price deregulation has caused credit to be rationed more by price than by availability. Many individual savers benefitted from price deregulation because they could earn higher interest rates on their deposits.

Geographic deregulation has been particularly important to commercial banks and bank holding companies, which were prevented by federal and state banking laws from offering full service interstate banking. The Office of the Comptroller of the Currency made rules that have expanded intrastate bank branching. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328) authorized nationwide interstate banking through the holding company format effective September 29, 1995. Effective June 1, 1997, under this law, the federal bank regulatory agencies may approve mergers between banks in different states unless the home state of one of the banking institutions has opted out by enacting a law explicitly prohibiting merger transactions involving out-of-state banks that applies equally to all out-of-state banks.[24]

In 1991, the National Credit Union Administration permitted credit unions to share branches, thus giving them an inexpensive way of expanding their geographic coverage.[25] In May 1992, the Office of Thrift Supervision permitted nationwide branching by all thrift institutions.[26]

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[23] For an overview of the taxation of life insurance, see CRS Report RL32000, *Taxation of Life Insurance Products: Background and Issues*, by Andrew D. Pike (consultant).

[24] CRS Report 94-744, *The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994*, by M. Maureen Murphy, pp. 1-2. This report is out of print but available on request from the author.

[25] Dean F. Amel, "Trends in the Structure of Federally Insured Depository Institutions, 1984-94," *Federal Reserve Bulletin*, vol. 82, no. 1, Jan. 1996, p. 4.

But credit unions still have some restrictions on branching. For example, a federal credit union may not establish a new branch office for the purpose of adding a group [combining with another credit union through a multiple-group charter].[27]

Product deregulation is blurring the distinctions among products offered by different types of depository institutions (e.g., checking accounts, credit cards, mortgages, etc.). Product deregulation has been accelerated by the mergers of some large financial and nonfinancial firms. Also, many firms have found methods of circumventing existing laws in order to offer additional financial products. The enactment of the Gramm-Leach-Bliley Act (P.L. 106-102) in 1999 facilitated "affiliation among banks, securities firms, and insurance companies, permitting financial conglomerates to cross-sell a variety of financial products to their customers (one-stop shopping)."[28] This act also allowed "national and state banks to create financial subsidiaries for diversification into insurance sales and full-service securities activities under specified conditions."[29] In addition, this act permitted banking ("financial holding") companies to invest in nonfinancial businesses for a share of the profits.[30]

Deregulation has resulted in the rapid expansion of most services offered by credit unions. Larger credit unions tend to offer a wider range of services than smaller credit unions. Deregulation has been implemented by legislation and rulings by the National Credit Union Administration. But credit unions, compared to other depository institutions, still have restrictions on their powers to lend and invest funds. For example, the Credit Union Membership Access Act (P.L. 105-219) limits business loans to members to 12.25% of total assets.[31] Also, credit unions may only "extend lines of credit to their members, to other credit unions, and to credit union organizations."[32]

The Treasury compared the basic statutory and regulatory rules applied to depository institutions across four broad categories: institution powers, safety and soundness, regulatory enforcement authority, and consumer protection. The Treasury concluded that

> Federal credit unions generally operate within the same legal framework as other federally insured depository institutions. Most differences between credit unions and other depository institutions derive from the structure of credit unions. We found this to be most likely in the case of safety and soundness rules, where credit union operations interact directly with the operation of the rules. With regard to enforcement and consumer protection rules, few differences exist. Credit unions have fewer powers available to them than do banks and thrifts, but through CUSOs [credit union service organization], credit unions may provide their members with a panoply of sophisticated financial services and products that rivals the offerings of banks and thrifts.[33]

(...continued)

[26] Ibid.

[27] Kessler, p. 10.

[28] CRS Report RL30375, *Major Financial Services Legislation, The Gramm-Leach-Bliley Act (P.L. 106-102): An Overview*, by F. Jean Wells and William D. Jackson.

[29] Ibid.

[30] CRS Report RS21134, *Merchant Banking: Mixing Banking and Commerce Under the Gramm-Leach-Bliley Act*, by Gary Shorter.

[31] CRS Report 98-933, *Credit Union Membership Access Act: Background and Issues*, p. 3.

[32] Kessler, p. 5.

[33] U.S. Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions*, p. 24.

Arguments For and Against Taxation

Proponents of taxation of credit unions argue that deregulation has caused extensive competition among depository institutions. These institutions actively compete for deposits by offering the best terms, including the highest rate of return to depositors. Depository institutions also compete for borrowers by offering the best loan terms including the lowest interest rates. Proponents of taxation argue that the concept of the common bond has continued to weaken. For example, the OmniAmerican Federal Credit Union

> ... counts 137,000 members employed at 1,300 businesses and organizations, ranging from the Boy Scouts of America to Pier One Imports. At the end of 1996, assets totaled $517 million....[34]

Another example, the "Wescom Credit Union's field of membership includes the 16 million people living in Los Angeles, Ventura, Orange, Riverside, and San Bernardino Counties."[35]

Tax proponents maintain that vigorous competition between credit unions and other depository institutions justifies the same tax treatment for all institutions. They argue that, for market forces to allocate resources efficiently, depository institutions should have a level playing field. But, in this view, the income tax exemption for credit unions gives them a competitive advantage over other depository institutions. Credit unions pay no income taxes on earnings whether distributed or retained. Credit unions can earn tax free interest on their retained earnings. Proponents assert that credit unions have lower operating costs because of their tax exemption. Consequently, credit unions can pay depositors higher rates of return and charge borrowers lower interest rates. It can be argued that the income tax exemption for credit unions has enabled them to grow more rapidly than other depository institutions.

The American Bankers Association (ABA) states that, "Traditionally, credit unions were based on a simple concept: bring together a closely-knit group of people, pool their resources, and provide small loans for one another."[36] The ABA argues that the tax exemption has allowed some of these traditional credit unions to "morph" into "highly competitive financial institutions virtually indistinguishable from banks."[37] The ABA maintains that "credit unions that have adhered to the traditional principles should continue to benefit from the tax preferences."[38] But, the ABA argues that credit unions that have morphed into large, aggressive financial institutions should lose their tax exemption.[39]

Supporters of the credit union tax exemption emphasize the uniqueness of credit unions compared to other depository institutions. Credit unions are nonprofit financial cooperatives directed by volunteers for the purpose of serving their members. Credit unions provide many services free or below cost in order to assist members. These services include small loans, financial counseling,

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[34] Kenneth N. Gilpin, "Piggy Banks with Muscles," *New York Times*, vol. 146, no. 50,715; February 26, 1997, p. B1.

[35] *Testimony of Jeff Plagge on behalf of the American Bankers Association before the Committee on Ways and Means*, Nov. 3, 2005. Wescom Credit Union's website is http://www.wescom.org.

[36] American Bankers Association, *The Morphing of Credit Unions*, Washington, 2004, p. 1.

[37] Ibid., p. 2.

[38] Ibid., p. 3.

[39] Ibid., p. 2.

and low balance share drafts. The NCUA argues that the taxation of credit unions would create pressure to eliminate these subsidized services. Furthermore, taxing credit unions would raise the cost of credit to many people without an alternative source of credit. Concern has been expressed in Congress about the access of lower income families to basic depository services.

The American Bankers Association cites surveys that concluded that members of credit unions had higher average incomes, higher average educational levels, and a higher rate of home ownership than non-members.[40] Hence, the ABA argues that the credit union industry is giving a faulty image of their membership.[41] Yet an official of the Credit Union National Association cites a recent survey conducted by Gallup for the ABA that found that the average household income of bank customers was $51,000 per year compared to $46,000 per year for credit union members.[42] The Government Accountability Office (GAO) found that "the extent to which credit unions serve persons of modest means is not definitively known because of limited data and lack of indicators."[43] GAO also concluded that "Federal Reserve Board data suggest that credit unions serve a slightly lower proportion of low- and moderate-income households than do banks."[44]

Supporters of the tax exemption argue that credit unions are subject to certain regulatory constraints not required of other depository institutions and that these constraints reduce the competitiveness of credit unions. For example, "credit unions are not subject to the internal control reporting requirements that the Federal Deposit Insurance Corporation Improvement Act of 1991 ... imposed on banks and thrifts."[45] These restrictions arguably impose an implicit tax on credit unions.

Supporters of the tax exemption point out that

> Under changes made to the Internal Revenue Code by the ... Small Business Job Protection Act of 1996, financial institutions, including banks, thrifts, and their parent holding companies, ... [are] able to elect Subchapter S corporation status under the Code and generally receive pass-through tax treatment for federal income tax purposes if certain criteria are met.[46]

Thus, a financial institution with a Subchapter S status is generally not subject to the federal corporate-level income tax. The corporation's taxable income flows through to its shareholders in proportion to their stock ownership, and the shareholders pay federal income taxes on their share of this taxable income.

Supporters of the tax exemption point out that the Credit Union Membership Access Act (P.L. 105-219) states that

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[40] American Bankers Association, *Credit Union Reality Check*, 1996, p. 2.

[41] Ibid.

[42] Fred Stokeld, "Banks Getting Testy Over Competition from Credit Unions," *Tax Notes*, vol. 75, no. 1, April 7, 1997, p. 46.

[43] U.S. Government Accountability Office, *Issues Regarding the Tax-Exempt Status of Credit Unions*, Testimony before the House Committee on Ways and Means, Nov. 3, 2005, p. 19.

[44] Ibid., p.22.

[45] U.S. General Accounting Office, *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*, GAO-04-91 (Washington: Oct. 2003), p. 6.

[46] Federal Deposit Insurance Corporation, *Subchapter S Election for Federal Income Taxes*, Financial Institution Letter, Oct 29, 1996, p. 1. Available at http://www.fdic.gov/news/news/financial/1996/fil9691.html.

> The Congress finds the following:
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> ... Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.[47]

Debate in the 108th Congress

In the 108th Congress, top officials of trade associations representing credit unions and commercials banks advocated the interests of their members on the issue of the tax exempt status of credit unions.[48] On February 23, 2004, former Treasury Secretary John W. Snow stated that the Bush Administration opposed taxing credit unions.[49] On March 16, 2004, Donald E. Powell, Chairman of the Federal Deposit Insurance Corporation stated that

> ... credit unions ought to pay taxes. The playing field has shifted in recent years. We've gone from 20 credit unions with assets of more than $1 billion ten years ago to 83 such institutions today. More and more we're seeing credit union advertising touting the benefits of membership over doing business with a bank. In my view, if they are going to compete with banks then we should do our best to ensure that the competition is fair.[50]

On June 2, 2004, three major banking trade groups announced that they had jointed forces to campaign against the tax-exempt status of credit unions. The American Bankers Association, the Independent Community Bankers Association (ICBA), and the America's Community Bankers established the Inter-Trade Credit Union Coordinating Council to campaign against what they considered to be unfair competitive advantages of credit unions, including their tax exempt status.[51]

Debate in the 109th Congress

In the 109th Congress, the tax exempt status of credit unions continued to be debated. On February 23, 2005, Dale Leighty, Chairman of the Independent Community Bankers Association (ICBA), stated in a press release that

[47] P.L. 105-219, Sec. 2.

[48] Marcia Kass, "CUNA Outrage at ABA Priority to Remove Credit Union Tax Exemption Gets Shrug," *Daily Tax Report*, no. 79, April 26, 2004, p. G9.

[49] Marcia Kass, "Snow Praises Credit Unions' Economic Role, Says Administration Opposes Taxing Them," *Daily Tax Report*, no. 35, Feb. 24, 2004, p. G4.

[50] Donald E. Powell, "Remarks before the Independent Community Bankers Association," *FDIC Press Release*, March 16, 2004, p. 1.

[51] "Three Banking Trade Groups Unite to Challenge Credit Unions' Tax Break," *Daily Tax Report*, no. 107, June 4, 2004, p. G5.

> Given the enormous size of the tax subsidy credit unions are receiving, there should be clear and solid evidence that credit unions are fulfilling some unique or extraordinary need in today's highly competitive financial services sector—yet that is not the case.[52]

Mr. Leighty was referring to a Tax Foundation report sponsored by the ICBA, which was critical of the tax exempt status of credit unions.[53] In response, the Credit Union National Association (CUNA) published an analysis of the Tax Foundation report. CUNA defended the tax exempt status of credit unions and argued that the Tax Foundation study was flawed.[54]

On March 1, 2005, before the Credit Union National Association, then House Ways and Means Committee ranking Democrat Charles Rangel asserted his support for the federal tax exemption for credit unions.[55] On July 15, 2005, at the National Association of Federal Credit Unions' conference, a board member counseled representatives of credit unions on how to retain the tax exemption for credit unions.[56]

On November 1, 2005, the President's Advisory Panel on Federal Tax Reform issued its report, which included two proposals for fundamental tax reform. One proposal would broaden the income tax base and lower tax rates. The other proposal would eliminate most tax preferences and shift the current income tax base to primarily a consumption tax base. Neither of these proposals explicitly recommended the repeal of the tax exempt status of credit unions. Because these proposals would broaden the tax base, however, it is likely that each proposal would repeal the tax exemption.

Also on November 1, 2005, Ed Yingling, president and chief executive officer of the American Bankers Association (ABA), said that the ABA will use the courts to challenge the credit union tax exemption because the tax exemption gives credit unions an unfair competitive advantage over banks, particularly community banks.[57] On November 3, 2005, the Committee on Ways and Means held hearings concerning the tax exempt status of credit unions. On February 27, 2006, at a CUNA Conference, former Treasury Secretary John Snow reaffirmed the Bush Administration's support for the income tax exemption for credit unions.[58]

On March 22, 2006, former Chairman of the House Ways and Means Committee William Thomas sent a letter to Ms. JoAnn Johnson, Chairperson of CUNA, expressing concern about the independence and objectivity of the NCUA in collecting and analyzing data about the income

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[52] Robert T. Zung, "ICBA Cites Study in Push to Eliminate Tax Exemption Granted Credit Unions," *Daily Tax Report*, no. 38, Feb. 28, 2005, p. G8.

[53] John A. Tatom, *Competitive Advantage: A Study of the Federal Tax Exemption for Credit Unions*, Tax Foundation, (Washington: Tax Foundation, 2005), 28 p.

[54] Credit Union National Association, *CUNA Analysis of ICBA/Tax Foundation Study of the Federal Credit Union Tax Exemption*, (Washington, CUNA, March 24, 2005), p. 1.

[55] Alison Bennett, "Lawmakers, Officials Express Support for Credit Union Federal Tax Exemption," *Daily Tax Report*, no. 40, March 2, 2005, p. G8.

[56] "NAFCU Counsels on Retaining Tax Exemption for Credit Unions," *Daily Tax Report*, no. 137, July 19, 2005, p. G7.

[57] Marcia Kass, "ABA Plans to Use Courts to Challenge Credit Union Tax Exemption, Yingling Says," *Daily Tax Report*, no. 211, Nov. 2, 2005, p. G6.

[58] Marcia Kass, "Treasury Secretary Snow Reaffirms Support for Credit Union Tax Exemption," *Daily Tax Report*, No. 39, Feb. 28, 2006, pp. G4-G5.

characteristics of credit union members and the compensation of credit union executives.[59] In his letter, former Chairman Thomas stated

> ... we do not need a cheerleader collecting and analyzing information about whether credit unions are fulfilling the goals intended with their tax exemption. I ask that you be mindful of your proper role as an independent and objective regulator of credit unions as you move forward with your data collection project.
>
> I also want to notify you that I am asking the Government Accountability Office to expand its current review of credit union tax exemption to include an analysis of the independence and objectivity of the NCUA. The NCUA's vigilance is critical to ensuring thorough oversight of credit unions, as well as a balanced analysis of their tax-exempt status.[60]

In November 2006, the National Credit Union Administration released a report titled *Member Service Assessment Pilot Program*.[61] The NCUA stated the this report provided "the most conclusive data to date available on the membership profiles of FCUs [federal credit unions]."[62] The NCUA concluded that their study:

- Demonstrates that FCUs are serving those they have been chartered to serve—working individuals.
- Confirms the expectation that FCUs designated as low-income, with underserved areas, or with a community base have better opportunities to serve lower income groups and individuals and generally have more diverse membership profiles as compared to FCUs with more restrictive common bonds and fields of membership.
- Strengthens NCUA's previous position that changes in membership profiles do not occur immediately—they take time.[63]

But former House Ways and Means Committee Chairman William Thomas stated that the NCUA "still has much more work ahead of them with respect to transparency and data collection."[64] He also asserted that the NCUA had "overstated the strength of the results of the report."[65]

In November 2006, the Government Accountability Office published a report titled *Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements*.[66] The GAO found that

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[59] Kurt Ritterpusch, "Rep. Thomas Critical of NCUA Official's Call for Selling Congress on Continued Exemption," *Daily Tax Report*, no. 57, March 24, 2006, p. G1.

[60] Letter from Representative William Thomas, Chairman of the House Ways and Means Committee, to Ms. JoAnn Johnson, Chairperson of the National Credit Union Administration, March 22, 2006.

[61] National Credit Union Administration, *Member Service Assessment Pilot Program*, Nov. 3, 2006, 80 p.

[62] Ibid., p. 1.

[63] Ibid.

[64] Alison Bennett and Marcia Kass, Thomas Responds to Credit Union Report, Says More Data Needed on Membership," *Daily Tax Report*, Nov. 24, 2006, p. G2.

[65] Ibid.

[66] Government Accountability Office, *Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangement*, report no. GAO-07-29, Nov. 2006, 103 p.

> NCUA has established the low-income credit union program and allowed adoption of "underserved areas" to increase credit union services to individuals of modest means. Despite increased credit union participation in these programs and the expansion of community charters, the 2004 and 2001 Survey of Consumer Finances indicated that credit unions lagged behind banks in serving low- and moderate-income households. NCUA officials told GAO that, given the nascent nature of its two initiatives and the relatively recent shift to community charters, they did not yet expect observable changes in the data. Also, NCUA recently has undertaken a pilot effort to collect data on the income characteristics of credit union members. Because limited data exist on the extent to which credit unions serve those of modest means, any assessment would be enhanced if NCUA were to move beyond its pilot and systematically collect income data.[67]

GAO also stated that "executive compensation for federal credit unions is not transparent, largely because federal credit unions are not required to publicly file information on executive compensation."[68]

Debate in the 110th Congress

The President's budget for FY2008 did not propose any change in the tax exempt status of credit unions. As of January 15, 2008, no legislation has been introduced in Congress concerning the tax exempt status of credit unions.

In the first session of the 110th Congress, the U.S. Treasury introduced two major studies concerning corporate tax reform: "Business Taxation and Global Competitiveness," and "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century." These studies may be the basis for legislation in the second session of the 110th Congress.

Report on "Business Taxation and Global Competitiveness"

On July 23, 2007, the U.S. Department of the Treasury held a conference on "Business Taxation and Global Competitiveness." The Treasury released a background paper that argued that

> The current business tax base includes an array of special provisions that reduce taxes for particular types of activities, industries, and businesses. These provisions take the form of exclusion from income, deductions allowed or enhanced from what otherwise would be allowed, preferential tax rates, income deferral, and tax credits. Some of these provisions are intended to ease tax compliance and administration, such as allowing cash accounting for small corporations, but others were intended by Congress to encourage particular types of activity. The premise underlying many of the special provisions is that they promote activities that have spillover effects, or address various externalities or market failures. Unwarranted tax subsidies may lead to the misallocation of capital, as they encourage investment decisions based on tax characteristics rather than economic fundamentals, and generally reduce economic growth.

[67] Ibid., highlights page.

[68] Ibid., p. 6.

> Together, these provisions substantially narrow the corporate tax base, which requires that tax rates be higher in order to raise the same tax revenue. For example, it is estimated that these special corporate tax provisions narrow the corporate tax base by roughly 25 percent. If the tax base were broadened by removing these special provisions, the top corporate tax rate of 35 percent could be reduced to 27 percent, or, as an alternative, about 40 percent of investment costs could be written off immediately (i.e., expensed) by all businesses.[69]

The Treasury states that the United States has the second highest statutory corporate tax rate among countries in the Organization for Economic Cooperation and Development (OECD, an organization consisting of most developed countries).[70] The Treasury maintains that broadening the corporate tax base and reducing the statutory corporate tax rate would improve the global competitive position of the United States.[71]

The tax expenditures that the Treasury proposes to eliminate includes the "exemption of credit union income," which is estimated to raise $19 billion during the period FY2008-FY2017.[72] This $19 billion would equal approximately 1.53% of the total amount of $1,241 billion from the Treasury's proposed broadening of the corporate tax base.[73] According to a news report, President Bush is considering a fresh plan to cut tax rates for U.S. corporations to make them more competitive around the world.[74]

On July 25, 2007, Daniel A. Mica, President and CEO of the Credit Union National Association, sent a letter to Secretary of Treasury Henry M. Paulson that expressed concern about the Treasury report's listing of the tax-exempt status of credit unions as one of the business tax breaks that could be repealed in order to finance a reduction in the corporate tax rate.[75] Mr. Mica stated that "Such a listing contradicts the 2004 letter to CUNA from President Bush in which he stated, I support strongly the tax-exempt status of credit unions, and will continue to highlight the important contributions that credit unions make to our financial system."[76] Mr. Mica asserted that the Treasury report failed to indicate that banks receive substantial tax preferences including the corporate tax exemption for Subchapter S banks.[77]

On August 10, 2007, the National Association of Federal Credit Unions (NAFCU) indicated that in past statements the Bush Administration had supported the credit union tax exemption and urged the administration to continue supporting the exemption.[78]

On July 27, 2007, Edward Yingling, an official at the American Bankers Association, sent a letter to Henry M. Paulson, Jr., Secretary of the Treasury, that stated

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[69] U.S. Department of the Treasury, *Treasury Conference on Business Taxation and Global Competitiveness*, Background Paper, Washington, July 23, 2007, p. 7.

[70] Ibid., p. 35.

[71] Ibid., p. 1.

[72] Ibid. p. 11.

[73] Ibid.

[74] Peter Backer, "Bush May Try to Cut Corporate Tax Rates," *Washington Post*, Aug. 9, 2007, p. A1.

[75] Daniel A. Mica, *Letter to Secretary of Treasury Henry M. Paulson*, July 25, 2007.

[76] Daniel A. Mica, *Letter to Secretary of Treasury Henry M. Paulson*, July 25, 2007.

[77] Ibid.

[78] NAFCU Urges Bush to Reaffirm CU Support, NAFCU new release, Aug. 10, 2007, available at http://www.nafcu.org/.

> On behalf of the American Bankers Association, I applaud the Treasury Department's efforts to lower corporate tax rates to help maintain U.S. global competitiveness. This is critical to maintaining the long-term strength of our economy and the financial services industry. Identifying wasteful uses of tax preferences is an excellent way to make the tax system more equitable. One such wasteful tax preference—which is noted in your report in Table 2.1—is the tax exemption for credit unions[79]

Report on Competitiveness of the U.S. Business Tax System

On December 20, 2007, the U.S. Treasury issued a report titled *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*.[80] This report was a follow-up to the July 26th conference report and included the following statement:

> Three broad approaches for reforming the U.S. business tax system are outlined: (1) replacing business income taxes with a business activities tax (BAT), a type of consumption tax, (2) eliminating special business tax provisions coupled with either business tax rate reduction or faster write-off of business investment, potentially combined with the exemption of active foreign earnings, and (3) implementing specific changes that focus on important structural problems within our business tax system. Rather than present a particular recommendation, this report examines the strengths and weaknesses of the various approaches. The various policy ideas discussed in this report represent just some of the approaches that could be considered. This report does not advocate any specific recommendation nor does it call for or advance any legislative package or regulatory changes.[81]

In the first approach, the proposed business activities tax (BAT) is a subtraction-method value-added tax (VAT).[82]

The second approach concerning broadening the business tax base includes a table titled "Special Tax Provisions Substantially Narrow the Business Tax Base," which lists the exemption of credit union income.[83] As previously stated in the July 23, 2007, report, for the period FY2008-FY2017, this table indicates that the amount of revenue that would be raised by eliminating this "special tax provision" would be $19 billion.[84] The total estimated revenue yield from eliminating the business tax preferences (both corporate and noncorporate) would be $1,326 billion, which would allow a reduction in the top business tax rate (both corporate and non-corporate) from 35% to 28%.[85]

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[79] "Bankers Group Applauds Treasury's Efforts to Reduce Corporate Tax Rates, Opposes Exempt Status for Large Credit Unions," letter from Edward L. Yingling, official of American Bankers Association, to Secretary of the Treasury Henry M. Paulson Jr., July 27, 2007.

[80] U.S. Department of the Treasury, Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Dec. 20, 2007, 116 p.

[81] Ibid., p. ii of executive summary.

[82] For an explanation of a subtraction-method VAT, see CRS Report RL33619, *Value-Added Tax: A New U.S. Revenue Source?*, by James M. Bickley, pp. 3-4.

[83] U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, p. 48.

[84] Ibid.

[85] Ibid.

On December 21, 2007, in response to the second Treasury report, Daniel A. Mica, President and CEO of the Credit Union National Association, sent a letter to Secretary of the Treasury Henry Paulson. In his letter, Mr. Mica stated

> To achieve the goal of reduced corporate income taxes, the paper focuses on repealing various business tax breaks, listing the exemption of credit union income among the preferences. As we pointed out in our previous letter, such a listing wholly contradicts the 2004 letter to CUNA from President Bush in which he stated, "I support strongly the tax-exempt status of credit unions, and will continue to highlight the important contributions that credit unions make to financial system."
>
> We have already pointed out the inappropriate contrast between the report's silence on the substantial benefits of credit unions to consumers, while lauding Subchapter S Corporations and other flow-through entities that are part of what the report calls the "non-corporate sector" because credit unions are non-stock, not-for-profit cooperatives that operate for the mutual benefit of their members. They do not compete in the marketplace for investment funds with stock companies or other for-profit entities that offer a higher potential return than interest on a savings account.[86]

In response to the issuance of the second Treasury report, reportedly Keith Liggett, senior economist at the American Bankers Association, "applauded the idea of taxing credit union—especially large ones that have moved away from their mission of serving customers of modest means and are morphing into large sophisticated bank-like entities."[87] Mr. Liggett also reportedly said "if the subsidy is not going for its purpose, it questions the efficacy of maintaining this exemption, and if you are going to look at lowering corporate taxes, preferences just really distort the allocation of resources."[88]

Trends

In the future, technological change and deregulation may further increase competition between credit unions and other depository institutions. It should be noted that thrift institutions were exempt from the federal income tax until 1951. The tax exemption for thrift institutions was eliminated because Congress felt that the relationship between thrifts and their members had substantially changed. In the 1980s, 1990s, and through 2007, the credit union industry grew more rapidly than other depository industries, and this more rapid growth may continue. Since many believe that an economically neutral tax system requires that financial institutions engaged in similar activities should have the same tax treatment, the income tax exemption for credit unions may occasion continuing debate.

[86] Daniel A. Mica, *Letter to Secretary of Treasury Henry Paulson*, Dec. 21, 2007.

[87] Robert Barba, "Treasury Report Retains Notion of Taxing CUs," *American Banker*, vol. 173, no. 6, Jan. 9, 2008.

[88] Ibid.

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