Taxation of Credit Unions: In Brief

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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. At the inception of the federal income tax, credit unions along with thrifts and other mutual financial institutions were exempt from federal tax. Subsequent developments have seen thrifts and other mutual financial institutions lose their exemption. 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 If this exemption were repealed, both federally chartered and state-chartered credit unions would become liable for payment of federal corporate income taxes on their retained earnings but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 FY2015-FY2019 the Joint Committee on Taxation estimates that federal taxation of credit unions would yield revenue of approximately $12.7 billion.[1]

Credit Union Basics

What Is a Credit Union?

According to the Federal Credit Union Act of 1934 (FCU Act, 48 Stat. 1216), a credit union is a cooperative association formed for the purpose of promoting thrift among its members and providing them with a low-cost source of credit. Given the numerous bank failures and runs that occurred during the Great Depression, Congress wanted to enhance the ability of these cooperative organizations to meet the credit needs of their members, who were unable to obtain bank credit. The credit union industry has evolved over time such that many of the financial services that credit unions now provide are similar to those offered by banks and savings associations.

Despite providing similar products and services as banks, credit unions have the following distinguishing characteristics. They are member-owned cooperatives, with each member having one vote regardless of the amount of a member's deposits. Credit unions also do not issue capital stock; rather, they are nonprofit entities that build capital by retaining earnings. Credit unions may serve only an identifiable group of customers with a common bond (e.g., the employees of a particular firm, the members of a certain organization, or the members of a specific community).

The credit union industry, similar to the banking industry, has seen a long-term trend toward consolidation. As shown in **Table 1** the number of credit unions has declined steadily over the past 30 years. Over the same time period, credit union membership has roughly doubled and credit union assets have increased over tenfold. According to the Credit Union National Association (CUNA), at the end of 2014, there were 6,513 credit unions—3,924 federally chartered and 2,589 chartered under state law.[2]

[1] U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2015-2019*, committee print, 114th Cong., December 7, 2015, JCT-141R-15.

[2] Credit Union National Association, *Credit Union Report Year-end 2014*, http://www.cuna.org/Research-And-Strategy/DownLoads/curepd14/.

Table 1. Selected Credit Union Statistics

(1984-2014)

Year	Number of Credit Unions	Membership	Assets (in $ Millions)
1984	18,375	49,210,277	111,560
1994	12,551	67,406,890	298,935
2004	9,346	86,050,841	668,104
2014	6,513	101,460,027	1,144,680

Source: Credit Union National Association (CUNA), *Credit Union Report Year-end 2014*, http://www.cuna.org/Research-And-Strategy/DownLoads/curepd14/.

As a group, credit unions have grown larger in recent years and have expanded their offerings of financial products and services. However, as data from the National Credit Union Administration (NCUA) reported in **Table 2** shows, recent growth has been concentrated among the largest credit unions.

Table 2. Growth in Selected Credit Union Statistics

(by Credit Union Asset Class)

	Under $10 Million	$10 Million to $100 Million	$100 Million to $500 Million	Over $500 Million
Number	1,863	2,725	1,034	468
Average Assets	$4.08 million	$37.39 million	$221.78 million	$1,798.29 million
Share Growth	1.39%	3.03%	4.61%	7.47%
Asset Growth	1.38%	3.11%	5.00%	8.82%
Membership Growth	-1.69%	0.05%	2.68%	6.49%

Source: http://www.ncua.gov/AboutNCUA/historyCU.html.

Notes: Growth rates are from December 31, 2014, to September 30, 2015.

While **Table 2** indicates that credit union growth was most dramatic among credit unions with over $500 million in assets, other data point to credit union asset growth primarily occurring at the top end of this category—those with assets in excess of $2 billion.[3] While only a small share of all credit unions, these top 1.4% (91 credit unions) account for 38.4% of credit union assets and realized asset growth more than three times the average asset growth of all credit unions or more than seven times the asset growth of credit unions with assets ranging from $500 million to $1 billion—the next highest category.[4]

How Are Credit Unions Taxed?

Credit unions have never been subject to the federal income tax. The Attorney General of the United States ruled that credit unions were exempt from income tax because of their similarity to

[3] Credit Union National Association, *Credit Union Report Year-end 2014*, http://www.cuna.org/Research-And-Strategy/DownLoads/curepd14/.

[4] According to the CUNA data, credit unions with assets less than $100 million decreased in both numbers and total assets during 2013.

domestic savings and loan associations—whose business was at one time confined to lending to members—and cooperative banks operated for mutual purposes, which were specifically exempt by revenue acts.[5] The income tax exemption for mutual banks and savings and loan institutions was removed in the Revenue Act of 1951, but the act, for the first time, designated credit unions by name as being exempt from federal income tax.[6] No specific reason was given for continuing the exemption of credit unions. However, thrifts lost their tax exemption in the act as they were deemed to have lost their mutuality—their depositors and borrowers were not necessarily the same individuals. The tax treatment of credit unions and other financial institutions was further differentiated by the Tax Reform Act of 1986 (TRA86, P.L. 99-514).[7] Hence, federally chartered credit unions are exempt from all state and local taxes. States vary on the state and local tax treatment of state chartered credit unions.[8]

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. Depositors, however, would continue to pay taxes on the distribution (interest) paid on the checking and savings accounts.

Should Credit Unions Retain Their Tax Status?

Central to the question of whether credit unions should retain their current tax treatment may be how similar they are to other financial institutions.

Subchapter S Corporation Banks

While credit unions are commonly thought of as the only type of financial institution that does not face a corporate level tax, banks organized as subchapter S corporations also do not face corporate-level taxes.[9] In 1997, as a result of P.L. 104-188, small banks meeting eligibility requirements were allowed to become "S corporations, meaning that their income is taxed only once (at the individual income tax rates). In 2004, the American Jobs Creation Act of 2004 (P.L. 108-357) relaxed certain provisions which restricted some banks and thrifts from electing S-corporation status. As of 2015, the Federal Deposit Insurance Corporation (FDIC) reported that 2,054 insured banking institutions were organized as S corporations. These institutions are taxed in a manner similar to credit unions.

Common Bond

As mentioned above, one distinguishing feature of credit unions is that their membership is drawn from individuals that have a common bond. Credit union charters are granted by federal or state

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[5] U.S. Government Accountability Office, *Credit Union Reforms*, GAO/GGD-91-85, July 10, 1991, p. 290, http://www.gao.gov/assets/160/150755.pdf.

[6] U.S. Congress, Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Financial Institutions*, committee print, 99th Cong., 1st sess., September 12, 1985, JCS-38-85.

[7] Prior to TRA86, depository institutions benefited from several specific tax preferences. These provisions were removed by TRA86 as part of an effort reduce the tax system's effect on economic decisions.

[8] According to CUNA, over one-third of all credit unions are state-chartered, see *U.S. Credit Union Profile-Third Quarter 2015 Results* at http://www.cuna.org/Research-And-Strategy/DownLoads/National-Profile-Third-Quarter-2015-PDF/.

[9] For more information on subchapter S corporations see CRS Report R43104, *A Brief Overview of Business Types and Their Tax Treatment*, by (name redacted) .

governments on the basis of a "common bond." There are three types of charters: (1) a single common bond (occupation or association based); (2) multiple common bonds (more than one group each having a common bond of occupation or association); and (3) a community-based (geographically defined) common bond.

The interpretation of the common bond has loosened starting in 1982.[10] In that year, the National Credit Union Administration (NCUA), the primary regulator for federally chartered credit unions, allowed credit unions to draw from multiple groups. This loosening may have been a response to an increase in credit union failures resulting from limited diversification due to a strict interpretation of the common bond requirement.[11] In 1998 the Supreme Court ruled the NCUA overstepped its authority when it loosened the common bond requirement. Congress nullified the ruling almost immediately with the passage of the Credit Union Membership Act of 1998 (P.L. 105-219, CUMAA), which specifically permitted multiple-bond credit unions as well as an expansion of the field of membership definition pertaining to federal community charters.

NCUA officials contend that relaxation of chartering policies is necessary if federal credit unions are to remain viable given changes in the economic environment and financial industry developments.[12] The loosening of restrictions is believed to allow credit unions to better weather economic fluctuations through increased diversification of membership. Previously, credit unions were organized around single employers or occupational organizations, creating increased exposure to risks associated with economic cycles specific to an employer or occupation. As a result of these relaxations, credit union membership is an option for most individuals. According to multiple articles there are multiple credit unions that anyone can join.[13]

Organization and Governance

Another distinguishing feature is that individual credit unions are owned by their memberships. The members of a credit union elect a board of directors from their institution's membership (one member, one vote). Given that credit unions are financial cooperatives that return profits to their memberships, members' savings are referred to as "shares" that earn "dividends" instead of interest. Credit union loan and investment powers are more restricted than those of commercial banks. Credit unions can only make loans to their members, to other credit unions, and to credit union organizations. The investment authority of federal credit unions is limited by statute to loans, government securities, deposits in other financial institutions, and certain other limited investments.

The organizational structure of credit unions could be one reason why Congress may decide that credit unions should retain their current tax status. As mentioned above, Congress removed the thrift tax exemption because these institutions had evolved into commercial bank competitors and had lost their "mutuality," in the sense that the institutions' borrowers and depositors were not

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[10] John R. Walter, Not Your Father's Credit Union, *Economics Quarterly*, vol. 92, no. 4, Federal Reserve Bank of Richmond, (Fall 2006).

[11] James A. Wilcox, "Credit Union Failures and Insurance Fund Losses: 1971-2004," Federal Reserve Bank of San Francisco, *Economic Letter*, vol. 2005-20 (August 19, 2005).

[12] U.S. Government Accountability Office, *Credit Unions: Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements*, GAO-07-29, November 30, 2006, http://www.gao.gov/new.items/d0729.pdf.

[13] Lisa Gerstner, "7 Great Credit Unions Anyone Can Join," *Kiplinger*, May 2015; Erin Lowry, "Credit Unions Anyone Can Join," *U.S. News and World Reports*, February 10, 2015; and Robert McGarvey, "Credit Unions Just About Anyone Can Join," *The Street.com*, January 5, 2016.

necessarily the same individuals making them more bank "like." Congress determined that, under these circumstances, their tax exemption afforded them an unfair advantage over commercial banks.

Business Lending[14]

Business lending by credit unions has received some Congressional attention in recent years. Under current regulations, member business lending on loans in excess of $50,000 is limited. These loans may not exceed the lesser of 1.75% of a credit union's net worth or 12.25% of total assets.[15]

The NCUA, as part of its Regulatory Modernization Initiative, has proposed a modification to the member business lending rule.[16] The proposed rule would provide credit unions with greater flexibility and autonomy in making member business loans through a shift towards a more principle-based methodology that emphasizes modern risk-management practices common to commercial banks. This shift from the current set of prescriptive rules would remove the requirement that credit unions submit requests for waivers to NCUA to originate member business loans.

This effort is viewed as an example of regulatory overreach by the American Bankers Association (ABA).[17] The ABA believes the proposed rule would circumvent congressionally mandated limits on member business lending. The ABA further believes that the proposed rule would pose serious safety and soundness concerns. Given the ABA represents a group that would face additional business lending competition under the proposed rule, it is not clear how salient are their concerns.[18]

In the 114th Congress several legislative proposals have been introduced that would expand credit union member business lending. The Credit Union Small Business Jobs Creation Act (H.R. 1188) would increase the member business lending cap from 12.25% to 27.5% of total assets. In addition, H.R. 1133 would exempt loans made to veterans from the member business lending cap, and H.R. 1422 would exempt loans for nonowner-occupied one- to four-unit dwellings from the member business lending cap.

Member Lending Terms

At their origins, mutual financial institutions (including credit unions) were thought to offer their members better access to credit and better credit terms because of the increased information available through the common bond that allowed membership. Over time this information advantage has been reduced through the advent of credit reporting agencies. A second reason it is

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[14] To examine this issue in depth, please see CRS Report R43167, *Policy Issues Related to Credit Union Lending*, by (name redacted).

[15] 12 U.S.C. §1757a and 12 U.S.C. §723 16(a).

[16] National Credit Union Administration, *Summary of Key Proposed Changes to NCUA's Member Business Loan Rule*, June 18, 2015, https://www.ncua.gov/About/Documents/Agenda%20Items/AG20150618Item6c.pdf.

[17] Brittany Dengler, Re: National Credit Union Administration; Member Business Loans; Commercial Lending; 12 C.F.R. Part 701, 723, and 741; 80 *Federal Register* 37898, July 1, 2015, American Bankers Association, August 28, 2015, http://www.aba.com/Advocacy/commentletters/Documents/NCUAProposedRulemakingPart723ABA'sCommentLetter.pdf.

[18] Not surprisingly, the National Association of Federal Credit Unions supports the NCUA efforts. As this group represents federal credit unions, it is not clear how salient are their reasons to support the proposed modifications.

thought that credit unions could offer better credit terms is as a result of a stigma effect associated with defaulting on a loan offered by those with the same common bond. As common bond requirements have loosened, it stands that this stigma effect may have diminished.

In spite of these changes, credit unions may still offer better credit terms to their members. As displayed in **Table 3** credit unions offer their members more attractive terms for many, but not all, financial products.

Table 3. Credit Union and Bank Rates for Selected Financial Products

(National Averages for All Credit Unions and Banks)

Product	Credit Unions	Banks
New car loan, 60 months	2.70	4.72
Used car loan, 48 month	2.78	5.16
30-year fixed rate mortgage	4.08	4.06
5/1-year adjustable rate mortgage	3.30	3.54
Home equity loan, LOC, 80%	4.01	4.34
Regular savings account- 1K	0.13	0.12
5 Year CD- 10K	1.49	1.22
Credit card, classic	11.61	12.59

Source: Data extracted by NCUA from SNL databases (http://www.snl.com) on January 7, 2016. The data represent interest rates reported by active banks and credit unions for the last Friday of the quarter (December 25).

The Government Accountability Office (GAO) made a similar finding using a different data source.[19] GAO compared the rates offered by small (assets of less than $100 million) and large (assets greater than $1 billion) banks and credit unions between 2000 and 2005 and found credit unions charged lower rates for consumer loans regardless of asset size. GAO found that for larger loans (such as mortgages) credit unions and banks of similar sizes offered virtually identical rates.

According to CUNA the more favorable terms offered by credit unions result in significant member and nonmember savings. According to CUNA member benefits totaled $7.1 billion in 2014.[20] In addition, CUNA found the existence of credit unions resulted in nearly $2.8 billion in nonmember benefits through increased competition as a result of their presence in the market.

The more favorable terms and resulting savings cannot be specifically tied to the more favorable tax status afforded credit unions relative to banks. For example, terms may differ based upon differences in borrower characteristics. Using Survey of Consumer Resources data, GAO found that in 2001 and 2004 credit unions drew fewer of their members from low- and moderate-income households than banks. Further differences in terms could also result from geographic differences.

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[19] U.S. Government Accountability Office, *Credit Unions: Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements*, GAO-07-29, November 30, 2006, http://www.gao.gov/new.items/d0729.pdf.

[20] Mike Schenk, *Credit Unions and Banks: Fallacies, Facts and Recent Trends Year-End 2014*, Credit Union National Association, http://www.cuna.org/Research-And-Strategy/DownLoads/FallaciesFactsTrends/.

Alignment of Incentives

As financial cooperatives, credit unions are formed to promote thrift and provide a low cost source of credit for their members. As the community credit unions serve is comprised primarily by its members, it can be argued that the incentives of credit unions are well aligned with the community they were created to serve. Serving this mission may, however, result in credit unions extending credit to members whose credit profile would exclude them from obtaining credit from traditional banks.

Credit unions are not the only financial intermediaries that pursue a mission-driven focus. Benefit Corporation (B-corp) banks are banks that operate under rigorous standards of social and environmental performance, accountability, and transparency.[21] Further, under the Community Development Financial Institutions (CDFI) Program, certified entities also focus on serving low-income people and communities that lack access to affordable financial products and services.[22] Unlike credit unions, these mission-driven institutions may face federal income taxes.

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[21] https://www.bcorporation.net/what-are-b-corps.

[22] For a complete description of the CDFI Program see CRS Report R42770, *Community Development Financial Institutions (CDFI) Fund: Programs and Policy Issues*, by (name redacted)