Research Report

February 1997

An Analysis of the Tax Treatment of Credit Unions
Florida and the Nation

Executive Summary

Credit unions have existed in this country for nearly 90 years. A credit union is a nonprofit cooperative association of people with a common bond which accepts shares from its members and makes loans to them. Every member of a credit union is an owner. Another unique feature of credit unions is they are exempt from most taxes.

Credit unions, like other financial institutions, have also changed remarkably over the years. Before 1970, they were generally very small institutions offering limited services. They operated within restrictive common bonds and served narrow, well-defined fields of membership. Since that time, the credit union industry has grown rapidly. Many individual credit unions have become quite large, full- service financial institutions serving a wide-ranging field of membership. This evolution has heightened the debate between credit unions and other depository institutions over the taxation of credit unions.

This report's aim is to provide information to assist the U.S. Congress, the Florida Legislature, federal and state regulators, those in the financial industry and the taxpaying public in understanding the issues involved in the debate over taxation of credit unions. This report does not make recommendations concerning the tax status of any depository institution but does suggest some considerations for the discussion of this issue.

This report examines the credit union industry, both nationally and in Florida. It analyzes the growth and evolution of credit unions and the laws concerning taxation and other industry regulations. The report also contains estimates of the value of various federal and state tax exemptions afforded credit unions, the future growth of the Florida credit unions and the potential future value of those tax exemptions. It also weighs various pro and con arguments regarding the taxation of credit unions.

History and Growth of Credit Unions

The first U.S. credit union was introduced in 1909. Pivotal events leading to the growth and change of the credit union industry included the establishment of the National Credit Union Share Insurance Fund in 1971, the authorization of credit unions to offer mortgages in 1978 and the authorization of transaction accounts in 1980. Credit unions began to become more like full-service institutions. These events have helped the credit union industry develop into what it has become today.

Nationally, credit unions had total assets of $1.0 billion, loans of $680 million and 4.6 million members in 1950. Today the national credit union industry has 70 million members, over $330 billion in assets and over $200 billion in loans. Although its market share is still relatively small, the credit union industry has also grown larger in relation to the size of banks. In 1980, credit unions comprised 3.6% of the nation's total bank and credit union assets. By 1995, that share has nearly doubled to 6.8%.

The trend, both in Florida and nationally, has been fewer, but larger credit unions. There are 275 credit unions in Florida today, down from 660 in 1969. However, in 1969 the average credit union had 1000 members and assets of $722,000. Following an industry trend of consolidation, the average Florida credit union today has over 12,000 members and assets of $57 million. As of December 1995, Florida credit unions have 3.2 million members, assets of $15 billion, deposits of $13 billion Executive Summary - continued

and loans of $9 billion. This report estimates that in ten years Florida credit unions will have 4.5 million members, assets of $33 billion, deposits of $28 billion and loans of $23 billion. h3>Relaxation of the Common Bond

The concept of common bond was essential to the early beginnings of credit unions. The first ones emphasized that a borrower's character was the foremost consideration in lending risk. The common bond became law with the 1934 Federal Credit Union Act when membership was to be limited to groups having a common bond of occupation, association or community.

Since then, federal and state regulators have liberalized common bond requirements. As a result, credit unions today typically have memberships made up of multiple groups of people. With credit unions now having 70 million members and membership penetration of 42% of all U.S. households, it is now apparent that credit unions serve the general public.

Credit union members are better educated, more likely employed full-time and more affluent than non-members. This is not surprising since most credit unions are organized around occupational bonds. However, it does point out that credit unions do not mainly serve people with limited access to credit and other financial services.

The Tax Treatment of Credit Unions

This report examines the history of tax treatment of credit unions. Both state and federally-chartered credit unions are exempt from federal income tax. Federally-chartered credit unions are also exempt from most state and local taxes. The state and local taxation of state credit unions is largely up to the individual states. Florida law exempts state-chartered credit unions from the same taxes federal ones are exempt from. So, the only taxes Florida credit unions pay are real and tangible personal property taxes, social security and unemployment compensation taxes.

It is important to note that savings and loans, mutual savings banks and cooperatives lost their tax- exempt status in 1951 when Congress decided these institutions had changed and considered them to be more like other profit-seeking financial institutions.

This report estimates the value of Florida credit union tax exemptions from federal and state income taxes as well as state intangibles, sales and documentary stamp taxes. The total value of these tax exemptions are estimated by Florida TaxWatch at $89.1 million annually, based on 1995 data. Of this amount, $64.6 million are federal taxes, $24.0 million are state taxes and $.55 million are local taxes. In ten years, Florida TaxWatch estimates the total annual value of the tax exemptions will reach $217.1 million -- $162.6 million for federal, $53.3 million for state and $1.2 million for local taxes.

The tax burden on a hypothetical Florida depository institution with assets of $50 million is also estimated. If this institution is a bank or savings association, it would incur a federal and state tax liability of over $300,000. If this institution is a credit union, it would pay none of these taxes.

The Pro and Con Arguments in the Debate on Taxation of Credit Unions

Proponents of taxing credit unions contend that deregulation has greatly increased competition between depository institutions. They say that the tax exempt status of credit unions gives them an unfair competitive advantage by reducing their operating costs and allowing them to offer higher rates of return and lower interest rates. Tax advantages can also help credit unions grow faster than taxable institutions by allowing greater capital accumulation. Proponents also argue that credit unions are greatly changed from what they once were. In short, large credit unions are hard to distinguish from banks. They also say that credit union have moved away from their original purpose of serving those with limited access to financial markets. And finally, proponents point out that Canada began taxing credit unions in 1972 and have continued to prosper.

Opponents of credit union taxation emphasize the non-profit nature of credit unions. And while tax exemption is a benefit, banks enjoy many competitive advantages, such as the ability to raise capital through the sale of stock and fewer restrictions on investments. It is argued that the taxation would create pressure to eliminate free or below cost services provided to members and would raise the cost of credit to many people without an alternative source of credit. Opponents also contend that since members can take their returns in several forms besides capital formation - dividends, lower loan rates or increased services - taxation would dangerously reduce capital. New, small and fast growing credit unions would have a greater tax burden than larger, older ones. Taxation would also make mergers more attractive to undercapitalized credit unions or those wishing to grow more quickly.

Conclusions

Credit unions have evolved over the years. Deregulation of financial institutions and the tax exemptions afforded credit unions have helped bring on their rapid growth. There are still credit unions that are small, limited service institutions with tight common bonds, but the number of large, full-service credit unions that exist today were not envisioned when the tax exemption was written into law. Many large credit unions today closely resemble mutual savings banks which are taxable.

Credit unions do help serve a public good and can help fill a under-served financial niche. Tax exemptions can help credit unions provide services to members at a lower cost or higher return than other financial institutions. But in considering the tax-exempt status of credit unions, the effect on competition is only one factor that should be examined by lawmakers. It must be remembered that the tax-subsidization of the industry benefits credit union members at the expense of tax-paying non- members. Tax exemptions should be viewed as "tax expenditures." This means that legislators should consider the value of tax exemptions and decide if they would be willing to fund a program at that level to produce the same benefits and would the absence of funding reduce or eliminate those desired public interests benefits.

One way to reduce the effect taxation would have on public benefits is to maintain the tax exemption for all but the largest credit unions. This would exempt the majority of credit unions and tax the ones that are currently getting the majority of the tax benefit. Newly formed credit unions would still receive the tax exemption as they become established. Smaller credit unions, which often retain the characteristics of nonprofit mutual organizations could remain free of taxation. Credit unions that more actively compete with and resemble other depository institutions could be subject to taxation. This would also mitigate some of the legitimate objections opponents have to taxation. These include barriers to forming new credit unions, higher failures of new and small credit unions and more mergers.

Large credit unions are not going to "go back to the way they were," nor necessarily should they. As with any organization, financial institutions need to change as the environment in which they operate changes. However, as economic and competitive conditions change, tax laws often also need to be re-addressed to consider those changes.

This report was researched and written by Kurt Wenner, Senior Research Analyst, under the direction of Dr. Neil S. Crispo, Senior Vice President, Research and Operations.
