

**ISSUE BRIEF: CREDIT UNION TAX EXEMPTION**

February 14, 2011

**SUMMARY**

In 1937 Congress granted credit unions with a federal tax-exempt status based upon their cooperative structure—that they are operated entirely by and for their members. Despite the evolution of products and services and expanded fields of membership, credit unions continue to operate as democratically controlled cooperative institutions, serving only their members, on a not-for-profit basis. Congress ratified the federal tax-exemption on several occasions, most recently in 1998 with the enactment of H.R. 1151, the *Credit Union Membership Access Act*. The banking lobby is vigorously opposed to credit unions' federal tax-exempt status, and has listed the elimination of the credit unions' tax advantage as a higher priority than enacting legislative initiatives to benefit their own industry. Contrary to the bankers' arguments, credit unions do pay taxes - payroll taxes, real estate taxes, and some other property taxes. In addition, dividends paid to credit union members are taxed as ordinary income.

**EFFECT ON CREDIT UNIONS**

The federal tax-exempt status is the crux of the credit union movement, and remains the priority issue for all credit unions, regardless of asset size, field of membership, and products and services offered. Many in the credit union movement believe credit unions would not be able to survive as cooperatives if the federal tax status were reversed, which could potentially lead to a sharp decline or elimination of credit unions. Credit unions also provide a market alternative that helps moderate increases in bank fees and charges for all consumers. Without credit unions, consumers would be greatly disadvantaged, and in some cases, be forced out of the financial mainstream.

**MCUL & AFFILIATES/CUNA POSITION**

The credit union federal tax-exemption is bound by the not-for-profit, cooperative nature of credit unions, not by the size of the credit union or the products and services that are offered. Credit unions' boards of directors are generally unpaid volunteers elected by the membership, and credit unions are restricted in who they can serve. The Michigan Credit Union League (MCUL) & Affiliates and the Credit Union National Association continue to highlight the Credit Union Difference, which reinforces the uniqueness of credit unions, in structure *and* service, from other financial institutions.

The banks have aggressively challenged the credit unions' tax exemption. The bankers also have had little difficulty in demanding taxation of credit unions while simultaneously advocating further tax relief for banks. The bankers have been very successful in lobbying Congress for tax changes that greatly enhance the attractiveness and tax position of banks that choose to elect Subchapter S status under the Internal Revenue Code. Bankers are also aggressively pursuing legislative action to allow national banks to organize as Limited Liability Corporations (LLCs). Both LLCs and Subchapter S corporations provide significant tax benefits by eliminating corporate-level taxation. Taxation occurs when these pass-through entities pay dividends to their shareholders. The MCUL & Affiliates and CUNA are not opposed to efforts by the banking industry to decrease its tax liability, but objects to their hypocrisy in trying to limit the tax benefits of competing institutions.

**STATUS**

The Ways and Means Committee held a hearing on November 3, 2005, to further review the tax-exempt status of credit unions, with then-Chairman Bill Thomas (R-CA) closing the hearing by stating that he would not try to subject credit unions to federal taxation.

On February 24, 2010, Federal Reserve Chairman Ben Bernanke testified before the House Financial Services Committee and was asked a question about legislation to raise the credit union member business lending limit. Bernanke replied, "The banks would complain, obviously, that if credit unions are allowed to do everything banks

can do, why are they tax favored? I think that's the trade off Congress has to consider". Chairman Bernanke is gravely misinformed. Credit unions have been making member business loans (MBLs) since their inception in the early 1900's. In the first 90 years of credit unions' existence in the United States, there was no MBL cap at credit unions. The current 12.25% of assets cap was an arbitrary limit imposed by Congress in the *Credit Union Membership Access Act in 1998* (CUMAA). As for the credit union tax exemption: It arises from credit unions' structure as not-for-profit, democratically-controlled cooperatives and that structure is unchanged over the past 100 years. The tax exemption has nothing to do with the breadth or volume of credit union product and service offerings – a fact clearly spelled-out by Congress in the CUMAA.

The credit union federal income tax exemption again came under scrutiny on August 27, 2010, when the Tax Reform Subcommittee of the President's Economic Recovery Advisory Board (PERAB) released its report called, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation".

As stated in the report, the three goals of the report's recommendations were to simplify the tax code, improve compliance, and reform corporate taxation. This Board was created by the President in early 2009 and the report stressed that the tax policy recommendations were not official Administration policy. Nevertheless, the report listed the option of eliminating tax expenditures like the credit union federal income tax exemption as an option for reforming corporate taxation. The report also suggested that credit union size may be a factor in deciding if and when a credit union becomes subject to federal corporate taxation. The report was submitted to the National Commission on Fiscal Responsibility and Reform, the federal commission tasked with issuing a report by December 1st and outlining measures that could be taken to reduce the federal deficit.

CUNA President and CEO Bill Cheney replied in a letter to the PERAB, stating, "It may be the case that not all tax preferences have lived up to expectations, but the credit union tax exemption is one of the highest-yielding investments the federal government has made." CUNA figures show that America's 92 million credit union members receive substantial benefits in the form of better pricing on services, saving them about \$7.5 billion a year. The \$7.5 billion savings to consumers is especially significant when measured against the \$1.5 billion in lost federal revenue a year that the government says is represented by the credit union tax exemption. (NOTE: On December 21, 2010, the Joint Committee on Taxation revised the cost of the credit union tax expenditure to \$0.3 billion for fiscal year 2011.)

It is interesting to note in the report that S corporations and S corporation banks, are discussed as distortions to the federal corporate tax code. The report mentions how S corporation employee-shareholders are able to avoid the full brunt of FICA payroll taxes through a loophole in the law. The report also states, "About half of business income now accrues to pass-through' entities like S corporations and partnerships; although the income of such pass-through entities is subject to tax at the individual level, it is excluded from the corporate tax." One-third of all US banks avoid corporate taxation by electing Subchapter S tax status. Credit unions are not opposed to banks seeking to lower their federal tax liability. However, this report neutralizes banker arguments that, because of the credit union tax status, they are at a competitive disadvantage in the marketplace. Finally, any bank can switch its charter to become a credit union. No bank has done so and thus illustrates the empty banker argument that credit unions should be subject to federal taxation.

On November 10, 2010, the National Commission on Fiscal Responsibility and Reform released its draft report on deficit reduction options. The report did not mention eliminating the credit union tax exemption but this Presidentially-commissioned report included an option to eliminate ALL federal tax expenditures as a way to reduce the federal budget deficit and simply the federal income tax code. In a letter, CUNA President and CEO Bill Cheney told Alan Simpson and Erskine Bowles, co-chairs of the National Commission on Fiscal Responsibility and Reform, that credit unions provide significant financial benefits to their 92 million members, saving them about \$7.5 billion a year, and that credit unions' favorable pricing also helps to improve bank rates and moderate their fees.

On December 1, 2010, the Commission released its final report that largely mirrored the recommendations in the draft report. On December 3rd, the members of the panel voted 11 to 7 in favor of passing the report. This was three votes less than the 14 votes necessary to pass the proposal and send it to Congress for an up or down vote. Even though the report did not receive a vote in Congress, several lawmakers have suggested they will introduce legislation to implement all or part of the Commission's report. In addition, anything in the report could be considered in future Congressional spending and revenue bills.

The Chairwoman of the National Credit Union (NCUA) Administration, the regulator for all federally-insured credit unions, wrote a letter dated November 22, 2010 to CUNA Chairman and CEO Bill Cheney expressing her concerns that a repeal of the federal tax exemption would threaten the very existence of credit unions as they are known today. During the 112<sup>th</sup> Congress, several committees have held hearings on reforming the federal income tax code. The credit union tax exemption has not been mentioned in any of these hearings and CUNA continues to meet with Members of the House and Senate, as well as their staff, regarding the importance of the credit union federal income tax exemption.

---

**ISSUE BRIEF: SUPPLEMENTAL CAPITAL**

*February 14, 2011*

**SUMMARY**

An interest by policymakers in increased capital at most types of financial institutions coupled with reduced capital ratios and strong headwinds against net income all point to the heightened need for supplemental capital for credit unions. Without access to additional forms of capital, many credit unions will be forced to curtail the growth of member service and burden members with higher loan rates and fees and lower dividend rates for years to come. Because a credit union's only source of capital is the retention of earnings, maintaining a given capital ratio can only be accompanied by asset growth if there is sufficient net income, and increasing a net worth ratio requires even higher levels of net income or slower growth rates. This would not be the case if retained earnings could be augmented to some degree by supplemental capital, which would increase a credit union's capital ratio as soon as it is issued. Under appropriate rules and guidelines that preserve the cooperative ownership and governance of credit unions, access to supplemental capital would be good for credit unions, their members, and the economy. Given the importance of adequate capital to the nation's federal deposit insurance systems, extending authority to credit union regulators to permit access to supplemental capital would also provide additional protection to the U.S. taxpayer.

**EFFECT ON CREDIT UNIONS**

Credit unions stand out as the only depository institutions in the U.S. without the ability to issue some form of capital instrument to augment retained earnings to build capital. All other U.S. depository institutions and most credit unions in other countries are permitted various forms of supplemental capital. Given the recent declines in capital ratios and net income, the case to amend the Federal Credit Union Act to provide access to additional capital for credit unions has never been more pressing.

**MCUL & AFFILIATES/CUNA POSITION**

While there are a variety of alternative capital options in the marketplace, not all of the forms available to other depository institutions will be appropriate because of credit unions' unique cooperative structure. The MCUL & Affiliates and CUNA believe supplemental capital would need to be created so that it in no way harms the unique credit union structure.

Specifically, the development of supplemental capital must:

- 1) Have no effect or potential effect on the cooperative ownership structure of credit unions;
- 2) Have no effect or potential effect on the ability of member-elected boards to govern their CU;
- 3) Be authorized and implemented in a way that has no adverse effect on the tax exempt status of credit unions.

The preservation of the tax exemption could be reinforced by a statement in the enabling legislation that such capital does not in any way change the tax exempt status of credit unions.

**STATUS**

While legislation has not yet been introduced to address supplemental capital, CUNA has prepared an extensive white paper in preparation. The MCUL & Affiliates will continue to encourage support for supplemental capital initiatives in the new Congress. We also encourage credit unions to educate members of our Congressional delegation on this important issue.

---

**ISSUE BRIEF: DEBIT INTERCHANGE FEES**

February 14, 2011

**SUMMARY**

Section 1075 of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires the Federal Reserve to issue regulations that would provide for reasonable debit interchange fees for electronic transactions and place limitations on payment card network restrictions. Credit unions and community banks rely upon small fees generated by electronic debit transactions to provide free checking services and to cover the significant costs associated with fraud and data security. If small issuers are unable to profitably offer debit services to their customers, the result could be decreased consumer choice and accelerated industry consolidation. Fortunately, because of these concerns, institutions with less than \$10 billion in assets were specifically exempted from this provision by the sponsor, Senator Dick Durbin (D-IL).

As directed by the Dodd-Frank Act, the Federal Reserve issued a proposed rule on the debit interchange fee provision in early January with a public comment deadline of February 22, 2011. After closely reviewing the Fed's proposed rule, the MCUL & Affiliates and CUNA identified several issues that must be addressed to ensure the exemption for small issuers will properly work. The Fed proposal does not include any provision designed to enforce the carve-out for small issuers and has not taken into consideration the cost to smaller institutions to provide debit card services. For smaller institutions, the cost of providing debit services is greater than for larger institutions.

**EFFECT ON CREDIT UNIONS**

Proponents of the interchange language in the Dodd-Frank Act as well as the underlying language believe that they are targeting big banks and the payment card networks, and profess that their intent is not to harm small issuers. Their attacks against these entities miss the mark badly. The stinging impact of the reduction of interchange fee revenue hits the smaller institutions disproportionately, and, in the case of credit unions, trickles down to the credit union member. Large for-profit institutions can more easily absorb a reduction in interchange fee revenue; and, inasmuch as the interchange fee is a fee paid to the issuer, the impact on the payment card networks is negligible.

If the Fed does not develop strict enforcement measure to ensure small issuers are indeed exempt from the lower debit interchange rate required of large issuers, it is estimated that credit unions could potentially lose 80-90% of their current debit interchange fee revenues. **In Michigan, the provision to limit interchange will result in a loss of \$72.5 million of income for our credit unions, and will be a total of a \$1.7 billion hit for all credit unions nationally, if the carve out is ineffective.** The erosion of interchange fee revenue seriously threatens credit unions' ability to offer low-cost access to financial services that is often much lower than what banks offer. Debit interchange fee revenue would be reduced significantly as a result of the Fed's current proposal, forcing credit unions to recoup anticipated losses through other means such as new or increased fees on members.

**MCUL & AFFILIATES/CUNA POSITION**

Unless Congress will repeal the entire debit interchange provision in the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, further legislation may be necessary to require payment networks to develop a two-tier system protecting issuers under \$10 billion in assets. The MCUL & Affiliates supports a legislative hearing on this specific provision as the amendment was never allowed to be debated through the committee process prior to its enactment. Additionally, the MCUL & Affiliates and CUNA are strongly opposed to the Fed's current debit interchange regulatory proposal and urge all credit unions to write the Fed in opposition.

## **STATUS**

Due in part to our strong grassroots efforts, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit scheduled a hearing to discuss this provision for February 17, 2011. In preparation of the upcoming subcommittee hearing, the MCUL & Affiliates and CUNA continued communications with both Congress and the Fed on debit interchange. The MCUL & Affiliates recently asked Michigan Representatives Thad McCotter, Gary Peters, and Bill Huizenga (members of the House Financial Services Committee) to slow down the Fed's proposal so the Financial Institutions Subcommittee has time to study the current proposal and its effect on Section 1075.

Additionally, the MCUL initiated resolutions in both the Michigan State House and Senate that urge Congress to slow down the current proposal to ensure the Fed has the authority to enforce the carve-out and protect small issuers, as intended by Congress. House Resolution No. 21 passed the full House of Representatives on Thursday, February 10 and Senate Resolution No. 14 was passed unanimously by the full State Senate on February 15.

The MCUL continues to encourage all member credit unions to comment on the Fed's debit interchange fee proposal by the February 22 deadline.

---

**ISSUE BRIEF: MEMBER BUSINESS LENDING**

February 14, 2011

**SUMMARY**

America's small businesses are the engine of growth of our nation's economy. The effects of the sub-prime mortgage crisis have spread to all types of lending resulting in a reduction in the availability of business credit. As Congress continues to consider ways to help the economy recover and create jobs, the MCUL & Affiliates and CUNA support an economic stimulus option that would create jobs without increasing government spending or the size of government: Raise the statutory cap on credit union member business lending. The cap on credit union member business lending (currently 12.25% of the total assets of the credit union) has no economic, safety and soundness or historical rationale. It was enacted in 1998, and after a decade, it is time to remove this arbitrary restriction. Credit unions have been lending to their business-owning members for a century. Net charge-off rates for credit union business loans are lower than charge-off rates for business loans made by banks. At a time when banks are withdrawing credit from America's small businesses, credit unions have actually been expanding credit to small businesses. It makes economic sense to restore credit unions' full ability to lend to their business-owning members.

**EFFECT ON CREDIT UNIONS**

In the fall of 2010, Senator Mark Udall (D-CO) introduced new language that would increase the MBL cap to 27.5% of total assets for credit unions that meet the following criteria: 1) the credit union has been near the limit for four consecutive quarters (80% of amount allowed); 2) are well capitalized; 3) have no less than five years of underwriting and servicing member business loans; 4) have strong policies and experience in managing member business loans; and 5) satisfy other standards established by the NCUA to maintain the safety and soundness of credit unions. The Administration and NCUA have both publicly stated their support of this language. If the statutory cap on credit union MBL's was increased to 27.5% of total assets, it is estimated that credit unions could make up to an additional **\$10 billion in business loans in the first twelve months, creating 108,000 new jobs**. This represents significant economic stimulus that does not cost the taxpayers a dime and does not expand the size of government. Legislation introduced in 2011 will likely be modeled after Senator Udall's language, previously approved by both the Administration and NCUA.

**MCUL & AFFILIATES/CUNA POSITION**

In the current economic crisis, small businesses in Michigan continue to struggle in securing small business loans. In 2010, a new partnership was created with the MEDC's Small Business Technology and Development Centers (STBDC) across the state where more than 30 credit unions pledged an initial \$43 million for small business loans through the Credit Union Small Business Financing Alliance ([www.cusbfa.com](http://www.cusbfa.com)). Consulting and training is available to participating small businesses and entrepreneurs through twelve regional SBTDC offices, of which Michigan credit unions have partnered to provide options for local financing. While the program is off and running, increasing the statutory cap on member business lending will have a greater impact on access to credit for many small businesses. The MCUL & Affiliates and CUNA continue to encourage co-sponsorship of MBL legislation in an effort to raise the credit union member business lending cap.

**STATUS**

In the 2009-2010 session, bi-partisan legislation was introduced in both the House and Senate in an effort to increase the MBL authority of credit unions. Similar legislation will be re-introduced soon in the new Congress as the MCUL & Affiliates and CUNA seek legislative co-sponsors. Please continue to educate new members of Michigan's delegation on the MBL issue and encourage their support once legislation is introduced.

**Please continue to thank our previous co-sponsors of MBL legislation in the U.S. House**

Representative Fred Upton  
Representative Dale Kildee

Representative Candice Miller  
Representative John Conyers

Representative Gary Peters