M. STATE CHARTERED CREDIT UNIONS UNDER 501(c)(14)(A)

Introduction

State chartered credit unions without capital stock, organized and operated for mutual purposes and without profit are exempt from Federal income tax under IRC 501(c)(14)(A). Federal credit unions are considered to be instrumentalities of the United States, exempt from Federal income tax under the provisions of the Federal Credit Union Act, 12 U.S.C. S1768, thus qualifying for exemption under IRC 501(c)(1). The credit union area has been the subject of recent activity despite the small amount of published precedent in this area. This discussion is designed to provide the reader with background material in this area.

1. Legislative History

Specific statutory language granting exemption for credit unions first appeared in the Code in 1951. Prior to that time credit unions generally qualified for tax exempt status under revenue statutes exempting building and loan associations and cooperative banks. However, in 1951, Congress deleted from the Code the language according tax exempt status to mutual savings banks and federal and state savings and loan associations. While the legislative history of the Revenue Act of 1951 contains an extensive discussion concerning the reasons for the elimination of exempt status for mutual savings banks and domestic savings and loan associations, it is silent with respect to the purpose for the continuation of exempt status for credit unions.

However, the probable reason for the continued favorable tax treatment of credit unions is contained in the reasons underlying the removal of exempt status for mutual savings banks and savings and loan associations. In reference to mutual savings banks the legislative history of the Revenue Act of 1951 states:

> "Mutual savings banks were established to encourage thrift and to provide safe and convenient facilities to care for savings. They also have the responsibility of investing the funds left with them so as to be able to give their depositors a return on their savings. Mutual savings banks were originally organized for the principal purpose of serving factory workers and other wage earners of moderate means who, at the time these banks were started, had no other place where they could deposit their savings.

> "At the present time, mutual savings banks are in active competition with commercial banks and life insurance companies for the public savings, and they compete with many types of taxable institutions in the security and real estate markets. As a result your committee believes that the continuance of the tax-free treatment now accorded mutual savings banks would be discriminatory. So long as they are exempt from income tax, mutual savings banks enjoy the advantage of being able to finance their growth out of earnings without incurring the tax liabilities paid by ordinary corporations when they undertake to expand through the use of their own reserves. The tax treatment provided by your committee would place mutual savings banks on a parity with their competitors." (Senate Report No. 781, 1951-2 C.B. 476.)

The reasons for removing tax exempt status for mutual savings banks were also applied to savings and loan associations:

> "The grounds on which your committee's bill taxes savings and loan associations on their retained earnings, after making a reasonable allowance for additions to a reserve for bad debts, are the same as those on which mutual savings banks are taxed under the bill. Moreover, since savings and loan associations are no longer self-contained cooperative institutions as they were when originally organized there is relatively little difference between their operations and those of other financial institutions which accept deposits and make real-estate loans." (Senate Report No. 781, 1951-2 C.B. 478.)

Thus, the reasons for removal of tax exempt status for mutual savings banks and savings and loan associations was their fundamental departure from the principles and purposes of their formation. The difference between these organizations and other financial institutions subject to Federal income tax was, in the view of Congress, minimal. It follows that the purpose for the retention of the tax exempt status of credit unions in 1951 probably was the absence of any indications that credit unions had deviated from their original purpose and characteristics. Had credit unions resembled taxable financial institutions at that time, it seems probable that Congress might not have continued their exempt status while at the same time removing exempt status from mutual savings banks and savings and loans.

2. Characteristics of Credit Unions

Credit unions historically have had certain features and legal requirements which generally distinguish them from other financial institutions. The first and most significant of these is the requirement of a meaningful, written, and enforced common bond for its members. The types of common bonds for credit union membership have generally been described as follows:

(1) employees of a particular business or institution;

(2) members associated in a particular organization; or

(3) residents of a well-defined neighborhood or community.

Secondly, a major reason for the establishment of credit unions in this country was to provide their members with a source of personal loans, in small amounts and for a short term, which generally were difficult to obtain from other financial institutions, absent the payment of usurious interest rates.

A feature of credit unions historically distinguishing them from various other financial institutions is the limitation on membership to qualifying individuals. Thus, credit unions normally do not admit corporations to their membership. Another characteristic normally distinguishing credit unions from other financial institutions is the fact that credit unions rarely advertise, and when they do, it is generally limited to publications designed to reach only their membership.

3. Recent Developments -- The St. Mary's Bank Case

In the case of La Caisse Populaire Ste-Marie (St. Mary's Bank) v. United States, 425 F. Supp. 512 (D.N.H. 1977), the Service maintained that the organization in question was not entitled to exemption as a state-chartered credit union under IRC 501(c)(14)(A) because it had the following characteristics:

(1) it had no written or enforced common bond requirement for its membership;

(2) it did not limit its lending to small unsecured loans, but engaged primarily in real estate mortgage lending (80 percent

of its lending portfolio was devoted to commercial and individual real estate mortgage loans);

(3) it made various large loans to numerous corporations and businesses (real estate loans to one business exceeded $350,000);

(4) it was not chartered under the general credit union statute of the state in which it was located;

(5) it operated in direct competition with commercial banks, cooperative banks and savings and loans, and advertised that it was a full service bank via the general media in an effort to obtain new customers;

(6) it offered demand deposit (checking) accounts and other services and facilities characteristic of commercial banks; and

(7) it had a significant number of corporations and businesses as members.

The District Court determined that the organization in question was entitled to exemption as a state-chartered credit union under IRC 501(c)(14)(A), and the case was appealed to the Court of Appeals for the First Circuit which affirmed the District Court decision. On appeal, four issues were discussed:

(1) whether credit unions could permissibly offer such services as demand deposits (checking accounts) and real estate loans;

(2) whether the organization was adequately servicing the needs of its members for short-term unsecured loans;

(3) whether there was a requirement of a common bond between members of a credit union; and

(4) whether calling the organization a credit union was a "gross misuse of the name" (a principle enunciated in U.S. v. Cambridge Loan and Building Co., 278 U.S. 55 (1928)) or whether the State of New Hampshire could reasonably classify the organization as a credit union.

The Court of Appeals concluded that:

(1) a credit union could offer such services;

(2) no evidence was presented that the organization was not meeting the needs of its members for short-term unsecured loans;

(3) the finding of the District Court that a de facto common bond (French ancestry) existed between members was not clearly erroneous; and

(4) IRC 501(c)(14)(A) necessarily implies that state law controls the definition of the term credit union. The Court defined the term credit union as a democratically controlled, cooperative, nonprofit society organized for the purpose of encouraging thrift and self-reliance among its members by creating a source of credit at a fair and reasonable rate of interest in order to improve the economic and social conditions of its members.

4. Requirements for Exemption in Light of St. Mary's Bank

No further appeal by the Government in St. Mary's was made as the decision did not conflict with any decision of another appellate court or the Court of Claims and thus there was no basis for seeking a writ of certiorari. The Court of Appeals' decision held that the district court's finding of a "de facto" common bond was "not clearly erroneous" and was upheld. The case stands for no more than that the Service's factual determination was incorrect. The Court of Appeals impliedly reaffirmed the principle of a requirement for a common bond as well as the requirement that credit unions must provide their members with a source of short-term unsecured loans.

5. Expansion of Powers of Federal Credit Unions

It should be noted that the powers of federal credit unions have recently been expanded. Federal credit unions are now authorized to issue "share draft accounts" which are similar to checking accounts, and P.L. 95-22 allows them to engage in limited real estate first mortgage loans. In addition, P.L. 92-221 authorized federal

insurance for demand deposit checking accounts of state-chartered credit unions, indicating that Congress does not view the issuance of checking accounts by state-chartered credit unions as inconsistent with the credit union concept.

6. Legislative Proposal of the Administration

In addition, it should also be pointed out that H.R. 12078, "The Revenue Act of 1978" as proposed by the Treasury Department to carry out President Carter's 1978 tax recommendations, contained a provision to eliminate federal and state-chartered credit unions from the list of organizations that are exempt under section 501(c) of the Code. The provision in question was stricken from the bill which eventually became P.L. 95-600, the Revenue Act of 1978, (1978-3 (Vol. 1)), and we are unsure of its prospects for the future.