

Revisiting Taxation

Some see tax trade-off as path to more favorable regulations.

By Karen Bankston

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There may be two sides to every argument, but the debate over whether credit unions should hold fast against taxation has been pretty one-sided until recently. In a new twist on a knotty issue, some executives are suggesting that accepting taxation might be a fair trade-off in exchange for relaxing field of membership and business lending restrictions and opening the door to secondary capital.

However, others insist that credit unions must continue to support the long-standing tradition of tax-exempt status for non-profit institutions. They contend that there is no certainty of a silver lining in the form of more favorable regulations, and they dismiss attempts to link the case for taxation to the NCUA's request for a loan from the U.S. Treasury to shore up corporate credit unions shellacked by losses.

Tossing The Bailout Ball

Outside the credit union industry, proponents of taxation may try to make those connections. For example, [Credit Union Watch](#), a blog by Keith Leggett, senior economist with the American Bankers Association, noted in June that "the credit union industry will no longer be able to claim that their insurance fund has not received taxpayer assistance" when the NCUA Board began accessing a \$6 billion revolving loan from the Treasury authorized under the Temporary Corporate Credit Union Stabilization Fund.

To the implications of those observations, CUES member Gordon Simmons, CEO of [Service Credit Union](#), Portsmouth, N.H., responds, "Yes, NCUA may borrow from the Treasury, but every penny must and will be repaid. TARP funds were expended to banks and other manufacturers that may never be able to repay. They paid tax and essentially made a withdrawal of taxpayers' money to continue to exist. Credit unions should never be compared to them."

While the banking industry may argue that the Treasury loan swings the tax debate in its favor, Dennis Dollar, former NCUA chairman and principal partner in [Dollar Associates, LLC](#), Birmingham, Ala., says, "I can't imagine they're at the strongest position to argue that the credit union tax exemption is costing the federal treasury any real dollars."

First, Dollar notes, the best estimates are that taxing credit unions would bring in about \$2 billion annually-and that's before calculating what credit unions might save through permissible tax avoidance strategies. "That's real money, but in the overall scheme of the federal budget, it won't save or fund too many defense, education or other programs," he contends. "And it's not enough for Congress to go back on their historically different treatment of not-for-profit sectors."

Dollar compares credit unions' tax-exempt status to that of non-profit hospitals, rural electrical cooperatives, YMCAs, even National Geographic, in comparison to for-profit entities in the same industries. Taxing credit unions would amount to "far-reaching public policy change," he contends. "I don't think Congress will likely do it, especially not for such a small return."

Second, by accepting TARP funds as equity rather than loans to be repaid, banks are "not exactly in the most sterling position" to claim that credit unions should be taxed, Dollar says. The Treasury loan "is absolutely the opposite of TARP funds. It's not a grant, but a seven-year loan collateralized by the combined capital of U.S. credit unions."

Credit unions will shoulder the burden of the corporate stabilization levy over the next seven years, Dollar notes. "The payback will be significant. Credit unions don't like the situation, but they do like the solution that allows them to say, 'We paid back our losses.' That actually strengthens the credit union position over the long term."

Inside the credit union industry, the focus in the taxation discussion is less about federal bailouts and more about what credit unions might stand to gain in the regulatory arena. While Robert D. Ramirez, CCE, is no fan of paying more taxes, he says credit unions ought to have the option to sign on for a different regulatory scheme that permits broader access to new members and capital—even if that means additional taxes. Such an option might be possible under the creation of a new type of charter for a federal financial services cooperative, an idea first proposed by Wendell A. "Bucky" Sebastian, CEO of \$1.9 billion/204,000-member [GTE Federal Credit Union](#), Tampa, Fla. (see accompanying [article](#)).

As proposed by Sebastian, an FFSC would have the same cooperative and governance structure as a credit union without the restrictions on business, mortgage and consumer lending that currently apply to federal credit unions. However, this new type of financial institution would be taxed at the corporate rate for income in excess of operating expenses, dividends and reserves.

As CEO of [Vantage West Credit Union](#), Tucson, Arizona, Ramirez, a CUES member, likes that concept. "I'm not proposing that credit unions convert to banks, but we need additional options to operate as a business, and this charter might provide a means to negotiate an exchange to help us run our business as a business," he says.

As evidence that the current business plan available to credit unions is not working, he notes that consolidation trends in our industry—from more than 20,000 credit unions in the late 1970s to 8,000 today—have not resulted in increased market share, which has held steady at 6 percent.

"In order to increase our market share, we have to change our business plan," Ramirez says. "We currently have no access to secondary capital and limitations in business lending and field of membership."

More than a century after their introduction in the United States, the advantages of credit unions remain the best-kept secret in financial services—and that's not a good thing, Ramirez notes. In part, those benefits might be lost in translation for members and prospective members with high net worth who might look askance at the idea of a "not-for-profit cooperative" tending to their assets.

"The very words credit and union have a negative connotation in some parts of the country," Ramirez argues. "I've got friends here in Tucson who don't realize that credit unions offer investment services and commercial loans."

As a state-chartered \$1.1 billion credit union serving 105,000 members in three Arizona counties, Vantage West CU already pays unrelated business income tax. Paying additional taxes "is a tradeoff I would be willing to sit down and discuss with a federal examiner if that would make it easier for our members to do business with us," Ramirez says.

That trade-off might not benefit every credit union, but it ought to be an option for those that are running up against the limits on business lending, member recruitment and the generation of new capital, he insists.

Looking into these new options makes more sense than ever in the current economy, Ramirez adds. "I don't believe we can save our business into profitability. We have to grow it into profitability. We can't just sit here and wait for the storm to pass."

Simmons looks at the same trends in credit union consolidation as Ramirez and draws a different conclusion about the survival of our industry. "The credit unions that disappeared were owned by their members and simply ceased to exist for economic, competitive and legislative reasons," notes the CEO of \$1.4 billion, 125,000-member Service CU. "Taxation would just be another negative step that would spell the end of many more credit unions in today's fragile economy."

Holding fast that credit unions "must never unequivocally accept taxation as inevitable," Simmons is adamant that "credit unions will never receive anything of equivalent value now or in the future by being taxed."

Dollar's position is that "credit unions have the right to argue for more favorable regulation without having to give up the tax exemption to get it." In recent decades, for example, credit unions gained the regulatory authority to offer checking accounts and expand their fields of membership without giving up their tax-exempt status.

"The taxation of credit unions would bring about the end of credit unions as we know them," he insists. "What credit unions have now is restrictions on business lending, capital, and fields of membership. If you remove the tax exemption, they're left only with the restrictions."

Taking An 'Agnostic' View

Merriam-Webster's defines an agnostic as "a person who holds the view that any ultimate reality is unknown and probably unknowable." In suggesting that credit union executives and directors approach the subject of taxation as "agnostics," Peter Duffy, associate director of [Sandler O'Neill + Partners LP](#), New York, departs from that definition in two crucial ways. Far from unknowable, Duffy contends, the potential impact of taxation on credit unions can be calculated-and might offer some surprises.

Second, he is less willing to handicap the likelihood that taxation will become an "ultimate reality" in the wake of the crisis striking corporate credit unions, the corporate stabilization levy, the Treasury loan, and continuing questions about how the industry will emerge from the current shakeup in the financial services sector.

"Will credit unions be taxed? I don't know. Who can handicap what lawmakers will do?" Duffy says. "Should they be worried? Based on our modeling, it appears that credit unions would benefit greatly from adopting bank regulations with taxation."

Over the last year, Sandler O'Neill, a CUES Supplier member, has modeled the impact of taxation for more than 25 credit unions of a \$1+ billion each in assets. The firm's modeling incorporates a "very conservative assumption" of the income impact of less restrictive bank regulations, "similar to the rules the movement has tried to achieve through CURIA" (CU Regulatory Improvements Act).

Under the dual assumptions of that exercise-taxation in combination with more favorable regulations-the results of Sandler O'Neill's modeling is that all but one credit union overcomes the negative impact of taxation within 18 months; it takes the remaining credit union just over two years to begin to see a positive outcome from the shift in taxation and regulation.

What Would Be Gained

What credit unions would gain if more favorable regulations were adopted along with taxation are removal of field of membership restrictions and the business lending cap, the relaxing of rules related to asset risk weighting that inhibit growth and earning, and lower minimum capital requirements. The biggest gain would be in access to secondary capital. In effect, credit unions currently are paying a "regulatory tax" under the more burdensome regulations than those that apply to banks, Duffy contends. "The simple truth is that taxation is among the least of the true negative concerns facing credit unions," he argues.

What credit unions should be concerned about is how deeply mired the industry may be in bad debt, he says, suggesting that they should assess relatively rosy forecasts of the current financial footing with healthy skepticism. He notes that the estimates for the size of the corporate stabilization assessment have grown, with indications that more increases may be in store.

Duffy compares the size of NCUA's request for a \$30 billion Treasury loan to the \$6.1 billion NCUSIF fund, which implies that the size of the industry's credit problem is much greater than the resources of the NCUSIF. It is also five times the size of the so-far-stated \$5.9 billion price tag of the credit crisis at US Central and WesCorp corporate credit unions. The gap between the loan amount requested and the stated size of the credit crisis in the credit union movement could pose a "credibility risk," he contends. It could also have a major impact on the competitiveness of natural person credit unions.

It's crucial to keep the credit union industry's problems in the larger perspective of the national "economic calamity" represented by the growth of total U.S. household debt from \$4 trillion to \$13 trillion from 1990 to the end of 2007, Duffy suggests. Borrowing went berserk in an atmosphere of relaxed lending standards and banking regulations and rates set "inordinately low for an inordinately long period of time."

The leveraging of credit on a massive scale spread like a virus. For traditional lenders, an already competitive lending market ratcheted up to "a supply-and-demand equation completely out of whack," he says. Desperate for ways to grow and continue to make money, financial institutions soon became mired in volumes of questionable loans that continue to worsen.

"Banks started dealing with this a lot quicker than credit unions. They have problems, but they're actively closing down banks and marrying them together to resolve those problems." Also on the bank side, their insurance premiums are based on the risk in their lending portfolios, so riskier banks pay more.

"On the credit union side, everyone pays the same rate, so the well-run credit union doesn't get credit for being well run." In effect, well-run credit unions must subsidize their peers that made riskier loans. It also means that the well-run bank may have a further advantage in competing for households, Duffy warns.

On the other hand, Dollar contends that banks that survive the current crisis will emerge as even stronger competitors not because of any regulatory advantage but because "they've had the backing of the U.S. government during their most troubled times."

Banks are currently struggling with a credibility crisis over headlines about their financial woes and business practices, but after those headlines fade, "they will be able to rebuild using their large taxpayer bailout."

Whatever advantages banks may have over credit unions or vice versa, the current economic backdrop brings us back to "why we can't be comfortable that the mortgage-based securities problem in corporate credit unions is getting better," Duffy contends. In sum, he suggests that the loan from Treasury amounts to "trying to borrow our way out of a borrowing problem-that might be bigger than we can deal with."

In terms of recovery from the credit crisis, Duffy says we're in for the long haul. The borrowing balloon that expanded for 17 years before it burst is still showering us with fallout in the form of option and interest-only ARMs, issues in indirect lending, and credit card and HELOC delinquencies that are just starting to unfold.

"One of the catch words of the day is to be first balanced and thorough in understanding the issues facing us," Duffy recommends.

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