

REPEALING THE CREDIT UNION FEDERAL INCOME TAX EXEMPTION

ABSTRACT

Credit unions, both state and federally chartered, have been exempt from federal corporate income tax since 1934. Congress granted this exemption because credit unions provided much needed financial services to low-class and middle-class Americans whom banks would not do business with. In order to offer these lower rates, credit unions were—and still are to some extent—required to adhere to restrictions on how they operate.

This Note will explore how credit unions came to be, how Congress and the National Credit Union Administration have required credit unions to operate, and the reasoning behind granting credit unions a federal corporate income tax exemption. It will then explore how the credit union industry has evolved and changed significantly over time. Finally, this Note will recommend that the credit union tax exemption be removed.

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I. INTRODUCTION

Credit unions have been operating in the United States for over 100 years.¹ While both state-chartered credit unions and federal credit unions are operating in the United States, the history, customer base, financial regulations, and financial products of both types are similar.² This Note will focus primarily on why federal credit unions are tax exempt, how they have evolved over time, and whether they still deserve tax exempt status. It is important to note that the arguments made in this Note, although specifically mentioning federal credit unions, apply equally to state-chartered credit unions.

Credit unions were created in an effort to offer financial services to a group of Americans who had largely been ignored by other financial institutions.³ “Federal chartering of credit unions began in the midst of the Great Depression”⁴ Three years after federal chartering began, Congress granted federal credit unions an exemption from paying corporate income tax.⁵ Credit unions were granted this favorable tax treatment, which their banking counterparts did not receive, because “they have certain features that clearly distinguish them from other financial institutions.”⁶ Namely, they “provide financial services that were unavailable or difficult to obtain elsewhere to lower-income, unbanked individuals

1. See *La Caisse Populaire Ste-Marie v. United States*, 425 F. Supp. 512, 515 (D.N.H. 1976), *aff’d sub nom. La Caisse Populaire Ste. Marie v. United States*, 563 F.2d 505 (1st Cir. 1977).

2. John R. Walter, *Not Your Father’s Credit Union*, 92 FED. RSRV. BANK RICH. ECON. Q. 353, 360–62 (2006).

3. See Erica York, *Repealing the Federal Tax Exemption for Credit Unions*, TAX FOUND. (Oct. 16, 2019), <https://taxfoundation.org/repealing-credit-union-exemption> [<https://perma.cc/GAC2-Y7YP>].

4. *Id.*

5. *Id.*

6. *Credit Union Tax Exemption: Background*, NAFCU, <https://www.nafcu.org/cutaxexemption/background> [<https://perma.cc/R26Z-NBAG>].

with a strong common bond.⁷ This tax-exempt status has not been without controversy as it has been challenged in court and the Internal Revenue Service (IRS) recommended to the Secretary of the Treasury that the exempt status be revoked in 1962.⁸

This Note recommends that credit unions should not be exempt from paying federal corporate income taxes. Credit unions have devolved over time to no longer serve their originally intended purpose.⁹ They offer substantially similar services to similar customers as banks.¹⁰ Credit unions receiving this favorable tax treatment causes federal revenues to diminish at a more rapid rate as they take business from banks.¹¹ Because of these reasons, credit unions should no longer receive a corporate income tax exemption.

II. HISTORY AND ORIGINAL PURPOSE OF CREDIT UNIONS

A. *What Is the History of Credit Unions and How Did They Become Exempt from Paying Federal Corporate Income Taxes?*

In Germany, rapid social changes and economic hardship caused the lower class, newly released from serfdom, to struggle to raise capital for their farming, artisan, and trade operations.¹² Banks charged usurious rates and required collateral, which were both impractical requirements of these lower income people.¹³ In response, local government officials in two different parts of the country developed cooperative financial institutions which depended upon the members' ownership interest in the institution and the knowledge of their fellow members' credit worthiness as security for their loans instead of large amounts of collateral.¹⁴

7. York, *supra* note 3.

8. *See* La Caisse Populaire Ste-Marie v. United States., 425 F. Supp. 512, 515 (D.N.H. 1976), *aff'd sub nom.* La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977).

9. York, *supra* note 3.

10. *See id.*

11. *See id.*

12. JOHNSTON BIRCHALL, RESILIENCE IN A DOWNTURN: THE POWER OF FINANCIAL COOPERATIVES 6–8 (Int'l Lab. Off.: Geneva 2013).

13. *Id.*

14. *Id.*

Knowledge of the credit worthiness of one's neighbors meant loans were safer.¹⁵ Unlimited liability meant members had a keen interest in monitoring each other.¹⁶ The homogeneous membership base meant peer pressure to repay.¹⁷ There was a strong sense of communal solidarity that overcame the potential conflicts of interest between borrower and saver, and shareholder and manager.¹⁸

With this knowledge in hand, the credit union loan committee could make a low-risk and, therefore, low-interest loan to a credit union member. Borrowing members received low interest rate loans and the owners of the credit union—also members—were repaid with interest, which then was returned to members in the form of interest (also called dividends) on deposits (also called shares) in the credit union.¹⁹

Based on these principles, the first financial institution which could be called a credit union developed by 1864, and these developments allowed people of modest means to secure the capital they needed to fund their businesses and grow and save their wealth.²⁰ From their German roots, credit unions continued to evolve throughout Europe and they came to the United States in 1909 when St. Mary's Cooperative Credit Association was opened in Manchester, New Hampshire.²¹ Credit unions continued to expand—operating under state charters—and the Federal Credit Union Act of 1934 began the federal chartering of credit unions.²²

“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.”²³ Congress removed the tax-exempt status of mutual savings banks and savings and loan institutions (thrifts) in the Revenue Act of 1951 because the thrifts evolved beyond their original “purpose of serving factory workers and other wage earners of moderate means who, at the time these

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. Walter, *supra* note 2, at 354.

20. BIRCHALL, *supra* note 12.

21. *Historical Timeline*, NAT'L CREDIT UNION ADMIN., <https://ncua.gov/about/historical-timeline> [<https://perma.cc/P5KV-P5TS>] (Jan. 26, 2023).

22. York, *supra* note 3.

23. INTERNAL REVENUE SERV., M. STATE CHARTERED CREDIT UNIONS UNDER 501(C)(14)(A), at 1 (1979), <https://www.irs.gov/pub/irs-tege/eotopicm79.pdf> [<https://perma.cc/69VE-JA2B>].

banks were started, had no other place where they could deposit their savings.”²⁴ Congress found that these thrift institutions “lost their mutuality—their depositors and borrowers were not necessarily the same individuals.”²⁵ Instead, Congress found that these thrifts were “in active competition with commercial banks and life insurance companies for the public savings, and they compet[ed] with many types of taxable institutions in the security and real estate markets.”²⁶ Because these thrifts resembled and competed with taxable banks, Congress found that “the continuance of the tax-free treatment now accorded . . . would be discriminatory.”²⁷

Congress removed the tax-exempt status of other thrifts, and for the first time, explicitly designated credit unions as “being exempt from federal income tax” in the Revenue Act of 1951.²⁸ Although the legislative history of the Act gives no indication as to why Congress retained and explicitly granted the tax exemption to credit unions at this time,²⁹ the reasoning given for the removal of the status from other thrifts shows that Congress believed that, unlike the other thrifts, credit unions

had not departed from their original purpose and did not resemble taxable financial institutions. In 1979, when discussing how Congress revoked the tax exemption for other financial institutions in 1951, the IRS noted, “Had credit unions resembled taxable financial institutions at that time, it seems probable that Congress might not have continued their exempt status.”³⁰

Since the Revenue Act of 1951, the exemption has come under attack, specifically from the banking industry.³¹ In fact in 1998, the American Bankers Association (ABA), along with several banks, won a U.S. Supreme Court case against the National Credit Union Administration (NCUA) because the NCUA “overstepped its authority when it loosened the common bond requirement.”³² The common bond requirement will be discussed later in this Note. However, Congress passed the Credit Union Membership Access Act of 1998 which quickly made this

24. S. REP. NO. 82-781, at 22–28 (1951); York, *supra* note 3.

25. DONALD J. MARPLES, CONG. RSCH. SERV., R44439, TAXATION OF CREDIT UNIONS: IN BRIEF 3 (2016).

26. S. REP. NO. 82-781, at 25–27 (1951).

27. *Id.* at 25; *see* York, *supra* note 3.

28. MARPLES, *supra* note 25, at 3.

29. *Id.*

30. York, *supra* note 3 (citing INTERNAL REVENUE SERV., *supra* note 23).

31. *See, e.g.*, Nat’l Credit Union Admin. v. First Nat’l Bank & Tr. Co., 522 U.S. 479 (1998).

32. MARPLES, *supra* note 25, at 4 (citing *Nat’l Credit Union Admin.*, 522 U.S. at 479).

Supreme Court ruling irrelevant because the legislation specifically allowed the NCUA action challenged in the case.³³ “[T]he credit union industry has grown in size, expanded in scope, appears to have little distinction from banks, and engages in activities like that of their taxed competitors”³⁴ The congressional action taken in 1998 is an example of Congress enabling credit unions to stray from their original purpose while not striking down their exempt status.³⁵

B. What Was the Original Purpose of Credit Unions and What Makes Them Uniquely Exempt from Corporate Income Tax?

“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.”³⁶ Congress justifies the tax-exempt status of credit unions because of this noble purpose and it requires credit unions to behave in a specific manner in order to qualify.³⁷ The required behavior forces credit unions to “generally have three distinguishing characteristics to justify their exemption from federal income taxes: a restricted customer base, low- and middle-income members, and types of services offered.”³⁸

1. The Common Bond Requirement

Credit unions must restrict their customer base to members with a “meaningful, written, and enforced common bond for its members.”³⁹ This requirement has evolved substantially over time and it offers both advantages for credit union operations as well as disadvantages in the size of its potential customer base, which are used by Congress to justify its tax-exempt status.⁴⁰ “Since its enactment in 1934, the Federal Credit Union Act has limited membership in federal credit unions to those with ‘a common bond of occupation or association, or to

33. *See id.* at 4; Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified at 12 U.S.C. § 1759).

34. York, *supra* note 3.

35. *See* Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified at 12 U.S.C. § 1759).

36. MARPLES, *supra* note 25 (citing Federal Credit Union Act, Pub. L. No. 73-467, 48 Stat. 1216 (1934)).

37. *See* York, *supra* note 3.

38. *Id.*

39. INTERNAL REVENUE SERV., *supra* note 23, at 3.

40. *Id.* at 2.

groups within a well-defined neighborhood, community, or rural district.”⁴¹ The history of the common bond dates back to at least the 1850s where artisans founded cooperative financial institutions for the purpose of purchasing raw materials and these cooperative financial institutions evolved into credit unions.⁴²

Due to their goal of providing credit to people who would not be able to put forth collateral for a bank loan, the common bond helped provide security to lenders for a couple of reasons.⁴³ First, credit unions used the common bond because it gave their “members better access to credit and better credit terms because of the increased information available through the common bond that allowed membership.”⁴⁴ “Knowledge of the credit worthiness of one’s [neighbors] meant loans were safer.”⁴⁵ Second, the common bond would help discourage members from defaulting due to the “stigma effect associated with defaulting on a loan offered by those with the same common bond.”⁴⁶

While these restrictions provide an alternative to collateral requirements for financial institutions lending money to lower-credit consumers, they also restrict the income-generating potential of credit unions.⁴⁷ “[B]y narrowing a credit union’s field of membership to those with a common bond, for example to workers of a certain factory, credit unions were limited in their ability to directly compete with taxable financial institutions that had unrestricted customer bases.”⁴⁸ Congress used the diminished earning capacity, compared to other financial institution counterparts, as justification for the federal income tax exemption granted to credit unions.⁴⁹

The common bond requirement historically gave credit unions a disadvantage in competing with other financial institutions for customers.⁵⁰ However, as discussed later in this Note, this requirement has been eased

41. U.S. GEN. ACCT. OFF., GAO-91-85, CREDIT UNIONS: REFORMS FOR ENSURING FUTURE SOUNDNESS 9 (1991) (quoting 12 U.S.C. § 1759 (2006)).

42. See BIRCHALL, *supra* note 12, at 6.

43. See MARPLES, *supra* note 25, at 1.

44. *Id.* at 5.

45. BIRCHALL, *supra* note 12, at 8.

46. MARPLES, *supra* note 25, at 5–6; see BIRCHALL, *supra* note 12, at 8 (“The homogeneous membership base meant peer pressure to repay.”).

47. See York, *supra* note 3.

48. *Id.*

49. See *id.* (“The common bond of members, which greatly limited credit union’s ability to compete with other financial institutions, was an original case made for the tax exemption.”).

50. See *id.*

substantially over the years, and the common bond of credit union members has deteriorated.⁵¹

2. *What Kind of People Can Be Members of Credit Unions?*

Credit unions “have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.”⁵² From their beginnings in 1800s Europe where “[p]eople remained poor through lack of capital, and lacked capital because they were poor[,]” credit unions existed to serve people who could not meet the financial requirements for credit from banks.⁵³

In 1939, according to Credit Union National Association (CUNA) statistics, federal credit unions had 2,251,466 members with total savings of \$160,818,740 and total loans of \$146,234,771.⁵⁴ The CUNA shows that federal credit unions held \$71.43 in savings per member and lent \$64.95 per member.⁵⁵ Adjusted for inflation, the value of those amounts in 2021 and 2022 would be \$1,432.72 and \$1,302.75 per member respectively.⁵⁶ These low amounts are indicative of credit unions fulfilling their purpose of serving lower-income people because the inflation-adjusted savings per member of \$1,432.72 would place the average credit union member below the 20th percentile in income in the United States today.⁵⁷ Clearly, shortly after their inception credit unions served mostly lower income individuals.⁵⁸ However, as will be discussed later in this Note, the average income of a credit union member has increased significantly over time.⁵⁹

51. *See infra* Part III.A.1.

52. *Credit Union Tax Exemption: Background*, *supra* note 6 (quoting Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified as 12 U.S.C. § 1759)).

53. BIRCHALL, *supra* note 12, at 7.

54. CREDIT UNION NAT’L ASS’N, UNITED STATES CREDIT UNION STATISTICS 1 (2022), <https://www.cuna.org/content/dam/cuna/advocacy/cu-economics-and-data/data---statistics/National.pdf> [<https://perma.cc/LKY2-95T7>].

55. *See id.*

56. *See Inflation Calculator*, US INFLATION CALCULATOR, <https://www.usinflationcalculator.com/> [<https://perma.cc/QD9C-6C6M>].

57. *See* Adrian Mak, *Average U.S. Savings Account Balance*, ADVISORSMITH (Nov. 24, 2021), <https://advisorsmith.com/data/average-savings-account-balance/> [<https://perma.cc/2F4Q-BWBP>] (“Income is the strongest predictor of bank account balance” The average bank account balance of a person below the 20th percentile in income was \$8,400 as of November 2021).

58. *See* CREDIT UNION NAT’L ASS’N, *supra* note 54; Mak, *supra* note 57.

59. *See infra* Part III.A.2.

3. *Services Offered by Credit Unions*

The Federal Credit Union Act of 1934 limits the types of loans that a chartered credit union can make and the types of assets that a chartered credit union can hold.⁶⁰ The Act restricts federal credit unions so that they are only able to receive deposits from their members.⁶¹ Functionally, a deposit at a credit union is not much different than at a bank, but a deposit at a credit union represents ownership in the credit union itself; meaning the deposits held by the credit union give the depositor an ownership share in the credit union, on which dividends are paid.⁶²

In order to receive a loan from a credit union, a person must be a member of that credit union.⁶³ “Credit unions face restrictions on the types . . . of loans they can offer. For example, until 1977, most federal credit unions could not offer real estate loans. [Instead], credit unions primarily provided small-value, nonmortgage loans to individuals and households; credit union assets were chiefly loans to individuals.”⁶⁴ Unlike banks, credit unions “avoid[ed] high-risk, high-return investments in favor of safe, lower-interest investments, such as small personal loans.”⁶⁵ Again, these loans provided an important service to our society because financial services to these individuals “were largely unavailable from traditional banks, especially for individuals of modest means during the Great Depression era.”⁶⁶

Credit unions offered an important source of funding to individuals who needed money for smaller expenditures—“for example, for the payment of a medical bill or to purchase a home appliance.”⁶⁷ Credit unions necessarily filled a niche because banks focused on loans to businesses and loans secured with collateral.⁶⁸ “The high fixed costs of extending a small-value loan, and the

60. See *La Caisse Populaire Ste-Marie v. United States*, 425 F. Supp. 512, 517 (D.N.H. 1976), *aff’d sub nom.* *La Caisse Populaire Ste. Marie v. United States*, 563 F.2d 505 (1st Cir. 1977).

61. York, *supra* note 3.

62. See *La Caisse Populaire Ste-Marie*, 425 F. Supp. at 522 (citing 12 U.S.C. § 1757 (2021)); Justin Pritchard, *What Is a Share Account?*, THE BALANCE, <https://www.thebalance.com/what-is-a-share-account-315405> [<https://perma.cc/5SH3-5HSP>] (Dec. 18, 2021).

63. York, *supra* note 3.

64. *Id.*

65. *Id.*

66. *Id.*

67. Walter, *supra* note 2, at 355.

68. See *id.*

significant risk of making an unsecured consumer loan to a borrower about whom the lender had little information on creditworthiness” forced banks and other financial institutions to charge rates which often exceeded usury ceilings for these smaller loans.⁶⁹ As previously stated, the unique feature of a common bond allows credit unions to make these smaller loans at a reasonable rate.⁷⁰

“Until 1977, federal credit unions were largely prohibited from making real estate loans”⁷¹ “With the exception of some securities investments, credit union assets were devoted almost completely to loans to individuals.”⁷² This structure was starkly different to savings and loans, mutual savings banks, and commercial banks which allocated a vast majority of their assets to mortgages, investments in securities, cash holdings, and business loans, while they devoted a small portion of their assets to uncollateralized loans.⁷³

The Federal Credit Union Act of 1934 codified the credit unions’ niche in small uncollateralized loans by limiting the lending power of credit unions to “loans with maturities not exceeding two years” and with “interest not exceeding [one] per centum per month”⁷⁴ Credit unions have largely grown out of the specialized niche they once occupied.⁷⁵ As I will discuss in more detail later in this Note, through amendments in regulations, court decisions, and congressional action, the services offered by credit unions have changed substantially since federal chartering began.⁷⁶

4. Other Justifications for the Tax-Exempt Status

In addition to the three main reasons already explained in this Note, credit unions are exempt from federal taxes “because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors”⁷⁷

One quality of credit unions which sets them apart from their banking counterparts is their not-for-profit status.⁷⁸ “Section 501(c)(1) of the Internal

69. *Id.* at 353.

70. *Id.* at 354.

71. *Id.* at 361.

72. *Id.*

73. *Id.*

74. Federal Credit Union Act, Pub. L. No. 73-467, 48 Stat. 1216, 1218 (1934).

75. *See, e.g.*, Act of Apr. 19, 1977, Pub. L. No. 95-22, 91 Stat. 49 (enabling credit unions to make secured residential real estate loans).

76. *See* MARPLES, *supra* note 25, at 2.

77. H.R. REP. No. 105-472, at 1–2 (1998).

78. *Credit Union Tax Exemption: Background*, *supra* note 6.

Revenue Code grants tax-exempt status to federal credit unions. Section 501(c)(14) of the Code does the same for state-chartered credit unions as long as they do not have capital stock, are mutuals, and are nonprofit.⁷⁹ Credit unions are considered non-profit institutions “because all the earnings of the institution, after the deduction from net earnings of necessary and prudent reserves, are distributed to the members, borrowers and savers alike, or held for the benefit of all members. . . .”⁸⁰ The reason behind the tax exempt status may not be *because* they are not-for-profit institutions; rather, “Congress *requires* all tax-exempt organizations be either non-profit or not-for-profit.”⁸¹ “There are only special kinds of organizations that Congress deems worthy of tax exemptions and that’s because they provide some manner of valuable social service.”⁸² Therefore, Congress deemed “the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means” a social service worthy of the non-profit status and the tax exemption.⁸³ The requirements imposed by the tax exemption and not-for-profit status are reasons for other unique qualities of credit unions.⁸⁴

“[Credit unions] 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.”⁸⁵ Unlike most banks, which are organized as corporations of various sizes ranging from small S corporations to publicly traded corporations, credit unions, both state and federal, are “cooperative or mutually owned organizations” meaning that the depositors are the owners of the credit unions.⁸⁶ “Given that credit unions are financial cooperatives that return profits to their memberships, members’ savings are referred to as ‘shares’ that earn ‘dividends’

79. Walter, *supra* note 2, at 363.

80. *La Caisse Populaire Ste-Marie v. United States*, 425 F. Supp. 512, 522 (D.N.H. 1976), *aff’d sub nom. La Caisse Populaire Ste. Marie v. United States*, 563 F.2d 505 (1st Cir. 1977).

81. *Why Are Credit Unions Tax Exempt? Do You Really Know?*, THE FIN. BRAND (Dec. 21, 2010), <https://thefinancialbrand.com/16153/why-credit-unions-have-a-tax-exemption/> [<https://perma.cc/7Z7L-387F>] (emphasis added).

82. *Id.*

83. *See* Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified at 12 U.S.C. § 1759).

84. *Why Are Credit Unions Tax Exempt? Do You Really Know?*, *supra* note 81 (“The section of Federal law concerning not-for-profits, 26 U.S.C. 501(c)(14), states that credit unions must ‘operate without profit and for the mutual benefit of its members.’”).

85. MARPLES, *supra* note 25, at 1.

86. *See* Walter, *supra* note 2, at 360.

instead of interest.”⁸⁷ Credit unions are member-owned because “Congress prohibits not-for-profit organizations from having private ownership.”⁸⁸

Besides being member-owned, credit unions are democratically organized.⁸⁹ “The members of a credit union elect a board of directors from their institution’s membership (one member, one vote).”⁹⁰ Democratic organization is not unique to credit unions or other tax-exempt organizations; in fact, democratic voting controls corporate decision-making.⁹¹ Meeting congressional requirements to be a tax-exempt organization also generally requires the elected board of directors of a credit union to be volunteers because Congress does not allow the boards of directors for non-profit entities to “personally benefit in any taxable way” from their service on the board.⁹² In addition to their three main unique features, credit unions are also given preferential treatment because of their organizational structure, which allows them to have a not-for-profit status.⁹³

III. WHY CREDIT UNIONS SHOULD LOSE TAX-EXEMPT STATUS

A. *Credit Unions No Longer Serve Their Intended Purpose*

Similar to the thrifts, which had their tax-exempt status removed by the Revenue Act of 1951 because they strayed from their original intent, credit unions have evolved to the point where they no longer serve the purposes they were designed to serve.⁹⁴ Credit unions did not receive the same fate in 1951 because credit unions had not “deviated from their original purpose and characteristics.”⁹⁵ “In the years since [1951], the credit union industry has grown in size, expanded in scope, appears to have little distinction from banks, and engages in activities like that of their taxed competitors”⁹⁶ Because credit unions have deviated from and no longer serve their intended purpose, Congress should revoke their tax exemption, like they revoked the status from thrifts decades ago.⁹⁷

87. MARPLES, *supra* note 25, at 4.

88. *Why Are Credit Unions Tax Exempt? Do You Really Know?*, *supra* note 81.

89. MARPLES, *supra* note 25, at 4.

90. *Id.*

91. *Why Are Credit Unions Tax Exempt? Do You Really Know?*, *supra* note 81.

92. *Id.*

93. *See id.*

94. *See* S. REP. NO. 82-781, at 22–28 (1951).

95. INTERNAL REVENUE SERV., *supra* note 23.

96. York, *supra* note 3.

97. *See* INTERNAL REVENUE SERV., *supra* note 23.

1. *Deterioration of the Common Bond*

The original requirement that “[f]ederal credit union membership shall be limited to groups having a common bond of occupation, or association, or to groups within a well-defined neighborhood, community, or rural district” has been greatly diminished.⁹⁸ The NCUA began expanding the definition of common bond in chartering manuals in the 1960s.⁹⁹ “In 1967, NCUA replaced its prior requirement that members be ‘extensively acquainted’ with the requirement that members ‘know’ each other.”¹⁰⁰ The NCUA then allowed lifetime membership privileges for members in 1968.¹⁰¹

The 1972 chartering manual defined three types of common bonds: occupational bonds, associational bonds, and residential bonds.¹⁰² These three types of common bonds were tightly defined in the 1972 manual, but their definitions loosened over time.¹⁰³

In 1972, a credit union with an occupational common bond required that the “[m]embers are employed by the same employer or in that employer’s related activities.”¹⁰⁴ The NCUA preferred that membership be restricted to people working in “one locality and required an explanation” for credit unions that included members that were not working in the same locale.¹⁰⁵ At that time, an associational bond meant that “[m]embers belong[ed] to an organization in which participation fosters common loyalties and mutual interests[,]” and the association must have been firmly established before it could form a credit union.¹⁰⁶ In 1972, a residential bond required that members be “residents within a well-defined geographical area who have a community of interests, activities, and objectives.”¹⁰⁷ Residential bonds were not favored by the NCUA in urban areas “[b]ecause residential groups are less likely than occupational groups to share a community of interest.”¹⁰⁸

98. See Federal Credit Union Act, Pub. L. No. 73-467, 48 Stat. 1216, 1219 (1934).

99. See U.S. GEN. ACCT. OFF., GAO-91-85, CREDIT UNIONS: REFORMS FOR ENSURING FUTURE SOUNDNESS 217 (1991).

100. *Id.*

101. *Id.* (stating “once a member always a member”).

102. *Id.* at 217–18.

103. *Id.*

104. *Id.* at 217.

105. *Id.*

106. *Id.* at 217–18.

107. *Id.* at 218.

108. *Id.*

Originally, the government required credit unions to draw membership only from a single common bond, but in 1982 the NCUA loosened that requirement and “allowed credit unions to draw from multiple groups.”¹⁰⁹ The viability of any financial institution is dependent upon diversification—which allows an institution to weather downturns in segments of the economy—and “a lack of diversification in the customer base (due to restrictive common bond requirements) also leads to a lack of diversification on the balance sheet.”¹¹⁰ This “concentration risk”¹¹¹ may be the flaw of the credit union system that the NCUA was attempting to cure by allowing credit unions to draw from multiple common bonds beginning in 1982.¹¹² “The loosening of restrictions is believed to allow credit unions to better weather economic fluctuations”¹¹³ Credit unions “organized around single employers or occupational organizations” faced significant “exposure to risks associated with economic cycles specific to an employer or occupation” and in an effort to mitigate these risks, the NCUA deteriorated the meaning of a common bond.¹¹⁴

As discussed previously, the common bond requirement was integral in what differentiated credit unions from their counterparts in the financial services industry in that it lowered credit risk, lowered fixed costs, and allowed credit unions to charge comparatively lower interest rates on their loans.¹¹⁵ The common bond created these credit advantages due to the availability of information about members and the stigma associated with defaulting within the community.¹¹⁶

Credit unions and their members drawn from a single common bond are likely to know each other through work, association involvement, or throughout their community, depending on the type of common bond.¹¹⁷ The closeness of the community gives the credit union a better estimate of credit worthiness because of the availability of information about each credit applicant.¹¹⁸ “Over time this information advantage has been reduced through the advent of credit reporting

109. MARPLES, *supra* note 25, at 4.

110. See W. Scott Frame et al., *The Effect of the Common Bond and Membership Expansion on Credit Union Risk 2* (Fed. Rsrv. Bank of Atlanta, Working Paper No. 2001-10, 2001), <https://www.econstor.eu/bitstream/10419/100938/1/wp2001-10.pdf> [<https://perma.cc/R24R-MZAA>].

111. *Id.*

112. See MARPLES, *supra* note 25, at 4.

113. *Id.*

114. *Id.*

115. See *supra* Part II.B.1.

116. See MARPLES, *supra* note 25, at 5–6.

117. See BIRCHALL, *supra* note 12, at 6–8.

118. See *id.*

agencies.”¹¹⁹ Now that reliable credit information is readily available to all financial institutions, credit unions lost one advantage of the common bond requirement that allowed them to offer more affordable rates than their counterparts in the industry.¹²⁰

The other reason the common bond lowered credit risk is the “stigma effect associated with defaulting on a loan offered by those with the same common bond.”¹²¹ Like the information advantage, this effect of the common bond has weakened as well.¹²² Without the “strong sense of communal solidarity” which created the “peer pressure to repay” among credit union members, it stands to reason that the loosening of the ties between members diminishes the peer pressure and stigma associated with defaulting.¹²³

By allowing multiple common bonds to be members at a credit union, the NCUA has greatly diminished the effect of a key factor that distinguishes credit unions from other financial institutions.¹²⁴ Similar to their thrift counterparts prior to 1951, credit unions strayed from their original form by allowing multiple common bond membership.¹²⁵

The NCUA is “the primary regulator for federally chartered credit unions.”¹²⁶ Beginning in 1982, the NCUA interpreted a phrase of the Federal Credit Union Act of 1934—“membership shall be limited to groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district”—to allow credit union membership to be comprised of multiple, unrelated groups.¹²⁷ Five banks and the ABA challenged the NCUA’s interpretation in *National Credit Union Administration v. First National Bank and Trust Co.*, and the U.S. Supreme Court held that such an interpretation was impermissible.¹²⁸

The victory by the banking industry at the Supreme Court was short lived, however, because later that year Congress passed the Credit Union Membership

119. MARPLES, *supra* note 25, at 5.

120. *See id.*

121. *Id.* at 5–6.

122. *See* BIRCHALL, *supra* note 12, at 8.

123. *Id.*

124. MARPLES, *supra* note 25, at 4.

125. *See id.* at 3–6.

126. *Id.* at 4.

127. *Nat’l Credit Union Admin. v. First Nat’l Bank & Tr. Co.*, 522 U.S. 479, 482–83 (1998) (quoting Federal Credit Union Act, Pub. L. No. 73-467, 48 Stat. 1216, 1219 (1934)).

128. *Id.* at 500.

Access Act of 1998 “which specifically permitted multiple-bond credit unions as well as an expansion of the field of membership definition pertaining to federal community charters.”¹²⁹ Unlike in 1951 where Congress removed the tax-exempt nature of many thrifts and mutual associations for straying from their original purpose, in 1998 Congress passed legislation which affirmatively enabled credit unions to evolve away from their original spirit of the common bond requirement.¹³⁰

Today, the common bond requirement bears little familiarity to the early requirement which used a sense of community to mitigate credit risks.¹³¹ The common bond requirement in current legislation allows a credit union to draw members from “[o]ne group that has a common bond of occupation or association;” more than one common bond or occupation; or “[p]ersons or organizations within a well-defined local community, neighborhood, or rural district.”¹³² Today because of the changes to the common bond requirement, almost anyone can join a credit union.¹³³ Because Congress and the NCUA have relaxed the common bond requirement, credit union members no longer have a “meaningful, written, and enforced common bond,” which shows how far credit unions have strayed from their original design.¹³⁴

2. *Serving a Wealthier Base*

As previously noted, credit unions were created as a “specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.”¹³⁵ By serving these lower-income people, credit unions acted as a tool for a poor person to pull themselves out of poverty by providing access to capital. This mission was a noble justification of the tax exemption for credit unions.¹³⁶

129. MARPLES, *supra* note 25, at 4 (citing Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913, 914–15 (1998) (codified at 12 U.S.C. § 1759)).

130. *See id.*; *see also* 112 Stat. at 914.

131. *See* MARPLES, *supra* note 25, at 3–6.

132. 12 U.S.C. § 1759(b).

133. *See* MARPLES, *supra* note 25, at 4 (“As a result of these relaxations, credit union membership is an option for most individuals.”) (referencing 112 Stat. at 914). *See generally* Sophia Acevedo, *14 Credit Unions in the US That Anyone Can Join*, INSIDER, <https://www.businessinsider.com/personal-finance/credit-unions-anyone-can-join> [https://perma.cc/M66C-XJ6Y] (Jun. 27, 2023, 5:28 PM).

134. INTERNAL REVENUE SERV., *supra* note 23, at 3; *see* York, *supra* note 3.

135. *Credit Union Tax Exemption: Background*, *supra* note 6 (citing 112 Stat. at 913).

136. *See generally* INTERNAL REVENUE SERV., *supra* note 23; York, *supra* note 3.

Unfortunately, “the evidence shows that credit unions do not serve low- and moderate-income people to any greater extent than banks.”¹³⁷

In 1939, federal credit unions held \$1,432.72 per member in deposits and lent \$1,302.75 per member as adjusted for inflation.¹³⁸ As of 2021, federal credit union membership was at 132,054,056 members with total savings of \$1,808,981,000,000 and total loans of \$1,279,075,000,000.¹³⁹ This volume results in \$13,698.79 savings per member and \$9,686.00 loans per member.¹⁴⁰ This staggering growth in loans and deposits per member illustrates a large change in the financial status of credit union members that has taken place since the early years of credit unions, as well as the effect of different products being offered by credit unions, which will be covered later in this Note.¹⁴¹ The increase in deposits and loans per credit union member has occurred over a long period of time, with different eras having different rates of increase.¹⁴² Using amounts adjusted for inflation and the 2021 values, the aggregate sum of loans and deposits has increased by approximately \$3 trillion since 1939.¹⁴³ Federal credit unions have also seen a massive influx of members in the United States—from 2.3 million in 1939 to 125.6 million in 2020.¹⁴⁴ The increase in members, however, has not offset the growth of credit union money handling, as the combined savings and loans per member has increased from \$2,735.46, adjusted for inflation, in 1939 to \$23,384.79 in 2021—an increase of 855 percent.¹⁴⁵

Not only has the wealth of credit union members increased compared to their humble beginnings, members, on average, are now even wealthier than bank customers.¹⁴⁶ In fact, a 2006 Government Accountability Office (GAO) study found that in 2004 “the median income of all households was \$42,000; bank

137. John A. Tatom, *Competitive Advantage: A Study of the Federal Tax Exemption for Credit Unions*, TAX FOUND. (Feb. 28, 2005), <https://taxfoundation.org/competitive-advantage-study-federal-tax-exemption-credit-unions/> [<https://perma.cc/32PK-PV7M>]; see INTERNAL REVENUE SERV., *supra* note 23; York, *supra* note 3.

138. CREDIT UNION NAT’L ASS’N, U.S. CREDIT UNION PROFILE 1 (2023), <https://www.cuna.org/content/dam/cuna/advocacy/cu-economics-and-data/data---statistics/National.pdf> [<https://perma.cc/NEV4-RKAU>].

139. *Id.*

140. *Id.*

141. *See id.*

142. *See id.*

143. *Id.*; *Inflation Calculator*, *supra* note 56.

144. CREDIT UNION NAT’L ASS’N, *supra* note 138.

145. *Id.*; *Inflation Calculator*, *supra* note 56.

146. York, *supra* note 3; see Tatom, *supra* note 137.

customers had a median income of \$43,000 and credit union customers had a median income of \$50,000.”¹⁴⁷

“Credit unions were originally designed to serve wage earners of small or moderate means.”¹⁴⁸ Today, however, credit unions are serving on average much wealthier members.¹⁴⁹ Despite evidence to the contrary, in 1998 Congress again justified the tax exempt status of credit unions on the fallacy that credit unions have a “specified mission” to serve low-income to middle-income people.¹⁵⁰ Similar to thrifts and mutual savings banks prior to 1951, credit unions no longer fulfill the role they were designed to fill—to provide credit to low-income to moderate-income members—and for that reason, credit unions should lose tax-exempt status.¹⁵¹

3. Expanded Financial Product Offerings

A major reason that credit unions were developed, and a justification for their tax-exempt status, was that they “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.”¹⁵² In addition to being restricted to only making loans to members, credit unions were limited by statute to make only “loans with maturities not exceeding two years.”¹⁵³ Credit unions fit in a niche where they made low-risk, low-return loans to “lower-income households that otherwise would not have access or would face prohibitive costs” to obtain credit, and Congress deemed this mission worthy of tax-exempt status.¹⁵⁴ In 1998, Congress reaffirmed its support of the mission of credit unions proclaiming that credit unions are tax exempt “because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.”¹⁵⁵

147. U.S. GOV'T ACCOUNTABILITY OFF., GAO-07-29, GREATER TRANSPARENCY NEEDED ON WHO CREDIT UNIONS SERVE AND ON SENIOR EXECUTIVE COMPENSATION ARRANGEMENTS 51 (2006).

148. York, *supra* note 3.

149. *See id.*; Tatom, *supra* note 137; U.S. GOV'T ACCOUNTABILITY OFF., GAO-07-29, GREATER TRANSPARENCY NEEDED ON WHO CREDIT UNIONS SERVE AND ON SENIOR EXECUTIVE COMPENSATION ARRANGEMENTS 51 (2006).

150. Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified at 12 U.S.C. § 1759).

151. *See* S. REP. NO. 82-781, at 25 (1951); York, *supra* note 3.

152. INTERNAL REVENUE SERV., *supra* note 23.

153. Federal Credit Union Act, Pub. L. No. 73-467, 48 Stat. 1216, 1217 (1934).

154. York, *supra* note 3.

155. 112 Stat. at 913.

The limited services originally offered by credit unions were narrowly tailored to achieving that end.¹⁵⁶

Since 1934, credit unions have evolved to offer many other financial products, to the point that the services offered by credit unions are strikingly similar to those offered by banks.¹⁵⁷ The evolution of credit union services did not occur overnight; instead, it occurred slowly over time with impactful changes of legislation mixed in throughout the years.

a. *Credit unions delve into the mortgage world.* One of the largest developments occurred in 1977 when Congress amended the Federal Credit Union Act, enabling federal credit unions to make residential real estate loans secured by a first mortgage on the real estate.¹⁵⁸ “Before these amendments passed, federal credit unions were limited to providing short-term mortgage loans such as second mortgages and mobile home loans”¹⁵⁹ Credit unions quickly dove into the world of real estate mortgages, and by the beginning of 1978, 6.2 percent of total credit union loan volume was secured by first mortgages.¹⁶⁰ Credit unions continued to expand into the mortgage market, and by 2005, 32 percent of all credit union loan volume was secured by a first mortgage.¹⁶¹ At the end of 2019, 33.7 percent of all credit union loans were comprised of fixed-rate first mortgages, which is the highest proportion of loan volume occupied by mortgages in credit union history.¹⁶²

Not only has mortgage volume supplanted other types of loan volume on credit union balance sheets, but credit unions have also managed to close the gap between bank and credit union mortgage production.¹⁶³ In 2020, independent mortgage companies like Quicken Loans dominated closed-end mortgage

156. York, *supra* note 3.

157. *Id.*

158. See Act of Apr. 19, 1977, Pub. L. No. 95-22, 91 Stat. 49 (allowing credit unions to make long-term mortgage loans with maturities up to 30 years).

159. Walter, *supra* note 2, at 371 (citation omitted).

160. *Id.*

161. *Id.* at 372.

162. Jim DuPlessis, *Credit Unions Kept Pace with Mortgages in 2020*, ALM CREDIT UNION TIMES (Feb. 24, 2021, 11:19 AM), <https://www.cutimes.com/2021/02/24/credit-unions-kept-pace-with-mortgages-in-2020/> [<https://perma.cc/SCT7-XDF9>].

163. See FENG LIU ET AL., DATA POINT: 2020 MORTGAGE MARKET ACTIVITY AND TRENDS 49 (Consumer Fin. Prot. Bureau 2021), https://files.consumerfinance.gov/f/documents/cfpb_2020-mortgage-market-activity-trends_report_2021-08.pdf [<https://perma.cc/MET5-MQ7X>].

production accounting for 60.4 percent of all closed-end mortgage production; the balance was mostly split between credit unions and banks, and banks accounted for 27.9 percent while credit unions made up only 7.9 percent of closed-end mortgage production.¹⁶⁴ Although this seems like a large gap, it will continue to close as credit union membership increases because credit unions can only make these loans to members and credit union membership has more than doubled since 1990, increasing from 61,598,065 members to 125,584,572 members in 2020.¹⁶⁵

Entry into the home mortgage market is a major illustration of credit unions straying from their original intent and justification for their tax-exempt status. One reason given for the removal of the tax-exempt status of thrifts and mutual savings banks was that these institutions were “in active competition with . . . taxable institutions in the security and real estate markets,” and “the continuance of the tax-free treatment [then] accorded mutual savings banks would be discriminatory.”¹⁶⁶ Today credit unions are in active competition with taxable institutions for real estate mortgages; in fact, during the fourth quarter of 2021, banks and credit unions on average offered almost identical rates for 30-year fixed-rate mortgages, with credit union rates coming in at only two basis points below the average rates offered by banks.¹⁶⁷ Because credit unions are in “active competition” with their taxable counterparts for real estate mortgages, it would be “discriminatory” to continue to afford credit unions with tax-free treatment.¹⁶⁸

b. *Credit unions now participate in other bank-like activities.* In addition to its entrance into the real estate mortgage world, the credit union industry now participates in many “activities that are beyond the scope of the credit union mission, including insurance products, real estate brokering and wealth management” services.¹⁶⁹ The expansion of services goes well beyond the original contemplation of credit union services described herein, and this expansion has not escaped the attention of Congress.¹⁷⁰ In a letter to the Chairman of the NCUA,

164. *Id.*

165. See CREDIT UNION NAT’L ASS’N, *supra* note 138; 12 U.S.C. §1757.

166. S. REP. NO. 82-781, at 25 (1951).

167. *Credit Union and Bank Rates 2021 Q4*, NAT’L CREDIT UNION ADMIN., <https://www.ncua.gov/analysis/cuso-economic-data/credit-union-bank-rates/credit-union-and-bank-rates-2021-q4> [<https://perma.cc/S8X2-CBP4>] (May 9, 2023).

168. See S. REP. NO. 82-781, at 25 (1951).

169. York, *supra* note 3.

170. See Letter from Orrin Hatch, Chair, U.S. Senate Comm. on Fin., to J. Mark McWatters, Chair, Nat’l Credit Union Admin. (Jan. 31, 2018), <http://icba-now.informz.net/icba-now/data/images/NWT/Documents/HatchLTR.pdf> [<https://perma.cc/2QNT-3NYJ>].

then-Senator Orrin Hatch was particularly concerned with credit unions participating in business lending and offering other services that are beyond the scope of their original mission to “serve the productive and provident credit needs of individuals of modest means.”¹⁷¹ Senator Hatch noted that while these pursuits may make financial sense for credit unions, “they should give us pause and cause a reflection on the core mission of credit unions and their tax-exempt purpose.”¹⁷²

Credit unions have always been able to make loans to individual members for a business purpose, but it was found that “poorly managed business lending programs . . . result[ed] in credit union failures.”¹⁷³ These failures led to the NCUA revising regulations regarding business lending and eventually, the NCUA’s business-lending definition and regulations were codified in the Credit Union Membership Access Act of 1998.¹⁷⁴ The 1998 law imposed regulations that “limited a credit union’s member business lending to the lesser of either 1.75 times net worth or 12.25 percent of total assets.”¹⁷⁵ These regulations, among others, were effective as they decreased business lending delinquencies from 8.2 percent in 1993 to 1.84 percent in 2000.¹⁷⁶ Despite the success of the regulations, “[t]he credit union industry has repeatedly tried to lift limits on what activities it can undertake, such as the caps on its business lending.”¹⁷⁷

Although credit unions have always had the ability to make business loans, the industry’s push to remove limits on these loans is antithetical to the credit union mission of favoring low-risk, low-return loans to individuals because “business loans are riskier than consumer loans.”¹⁷⁸ While it may make good business sense to move towards higher-risk, higher-return business loans, these loans do not further the mission of credit unions nor the justification of their tax-exempt status.¹⁷⁹

In addition to business lending, credit unions are involved in a whole host of activities that are not related to the mission of credit unions such as offering

171. *Id.* (quoting 12 U.S.C. § 1759 (1998)).

172. *Id.*

173. U.S. DEP’T OF THE TREASURY, CREDIT UNION MEMBER BUSINESS LENDING (2001), <https://home.treasury.gov/system/files/136/archive-documents/mblstudy.doc> [<https://perma.cc/X3VT-3M6A>] (document will download).

174. *See id.*; 12 U.S.C. § 1757a (1998).

175. U.S. DEP’T OF THE TREASURY, *supra* note 173; *see* § 1757a; 12 U.S.C. 1790d (1998).

176. U.S. DEP’T OF THE TREASURY, *supra* note 173.

177. York, *supra* note 3.

178. Tatom, *supra* note 137.

179. *See* York, *supra* note 3.

“insurance products, real estate brokering and wealth management, purchasing previously for-profit banks, and buying naming rights to sports stadiums.”¹⁸⁰ Without diving into each of these activities in-depth, it is easy to see how they do little to “serve the productive and provident credit needs of individuals of modest means.”¹⁸¹ As Senator Hatch said, while engaging in these activities “may be worthwhile pursuits, they should give us pause and cause a reflection on the core mission of credit unions and their tax-exempt purpose.”¹⁸²

B. Precedent Demands That the Tax-Exemption Be Removed

The Revenue Act of 1951 “revoked the tax-exempt status of several other types of financial institutions while retaining the credit union exemption.”¹⁸³ The Senate Report for this act indicated these financial institutions lost their tax-exempt status because they departed from their original purpose, and they were 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.”¹⁸⁴ The Report went on to say that the tax-exemption gave these institutions a competitive advantage over other financial institutions with whom they were competing because they were able to finance growth from earnings on which they did not incur taxes normally incurred by corporations.¹⁸⁵ The Report found that allowing the tax exemption accorded to these institutions “would be discriminatory” and applying equal tax treatment “would place mutual savings banks on a parity with their competitors.”¹⁸⁶

Like the financial institutions that lost their financial status in 1951, credit unions today have “departed from their original purpose” by offering a wide variety of financial products that have no bearing on the purpose of providing credit to low-income to moderate-income members, and this departure is evidenced by credit union membership being comprised of members with income higher than banking customers.¹⁸⁷ The expanded offerings of credit unions—including mortgage lending, business lending, and other services—show how credit unions have left their niche over time and are now directly competing with banks.

180. *Id.*

181. *See* Letter from Orrin Hatch, *supra* note 170 (quoting 12 U.S.C. § 1759 (1998)).

182. *Id.*

183. York, *supra* note 3 (citing S. REP. NO. 82-781, at 27 (1951)).

184. S. REP. NO. 82-781, at 25 (1951).

185. *Id.*

186. *Id.*

187. York, *supra* note 3.

In 1979, the IRS discussed with Congress removing the tax-exempt status of financial institutions while, for the first time, specifically granting the status to credit unions by name.¹⁸⁸ There, the IRS noted the institutions lost their tax-exempt status because of “their fundamental departure from the principles and purposes of their formation” and credit unions likely retained their status at that time due to “the absence of any indications that credit unions had deviated from their original purpose and characteristics.”¹⁸⁹ The IRS went on to say that if “credit unions resembled taxable financial institutions at that time,” they likely would have lost their exempt status then.¹⁹⁰ It has been over 40 years since this IRS text was published, and as discussed herein, credit unions continue to more closely resemble banks. Instead of removing the tax-exemption, thus far Congress has insisted on allowing credit unions to continue their expansion outside their niche.¹⁹¹ Instead of allowing credit unions to continue expanding their services and membership base to the point it no longer resembles the institutions created for the benefit of the low-middle class, Congress should follow its own precedent set in 1951 and abolish the tax-exemption.

C. Tax Policy and Fiscal Considerations Require Repealing the Exemption

1. The Principles of Tax Policy Are Violated by Exempting Credit Unions

“[T]here are a number of broad tax policy considerations that have traditionally guided the development of taxation systems. These include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, as well as flexibility.”¹⁹² By exempting credit unions from the federal income tax while taxing their competitors in the financial services industry, Congress is at least violating the principles of neutrality and efficiency.

“The principle of neutrality requires taxing similar economic activities the same.”¹⁹³ “A neutral tax will contribute to efficiency by ensuring that optimal allocation of the means of production is achieved[;]” whereas, a non-neutral tax creates inefficiency.¹⁹⁴ Non-neutral tax laws cause a “misallocation of resources:

188. INTERNAL REVENUE SERV., *supra* note 23.

189. *Id.*

190. *Id.*

191. *See, e.g.*, 12 U.S.C. § 1759 (1998) (authorizing multiple common bond membership).

192. OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY 30 (OECD Publ'g 2014), https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy_9789264218789-en#page1 [<https://perma.cc/ZJJ9-BVET>].

193. York, *supra* note 3.

194. OECD, *supra* note 192, at 30; York, *supra* note 3.

the tax-exempt industry can grow at the expense of the taxed industry, leading the tax-exempt industry to become larger and less productive than the taxed industry.”¹⁹⁵ Not only can a non-neutral tax law cause a tax-exempt business to generate significant revenues from which the government cannot extract a tax, but the tax-exempt business can use the tax breaks to undercut prices of the taxed entities, causing customers to leave the taxed entities in favor of the exempt.¹⁹⁶ The result of increasing tax-free business at the expense of taxed business compounds the adverse impact by growing untaxed revenues, shrinking taxed revenues, and the government not collecting billions of dollars of potential revenue.

As discussed herein, credit unions engage in substantially similar economic activities as taxed organizations, but they are not taxed in a similar manner. It is estimated that the tax-exemption creates 50 basis points of savings compared to taxed institution; meaning that, in a vacuum with all else being equal, credit unions could offer the same exact loans as a bank at rates that are half of a percent less than the banks charge.¹⁹⁷ Based on the mission of credit unions, it may seem that these tax savings would be passed on to the members by way of lower interest rates.¹⁹⁸ However, the majority of the tax savings—at least 33 basis points—are held by the credit union as retained earnings “accru[ing] to owners in the form of larger equity and larger assets.”¹⁹⁹ The extra income of tax savings “reinvested in the credit union provides new capital that allows the credit union to grow faster than other institutions.”²⁰⁰

A small portion—approximately six percent—of the tax savings are passed on to members through lower interest rates.²⁰¹ “There is some evidence that certain types of loans have lower rates at credit unions, especially for loans that have become less profitable and less available at banks, such as auto loans.”²⁰² The figure below shows the national average rates for credit union and bank products for both loan and deposit accounts:

195. York, *supra* note 3.

196. *See id.*

197. Tatom, *supra* note 137.

198. *See Credit Union Tax Exemption: Background*, *supra* note 6.

199. Tatom, *supra* note 137.

200. *Id.*

201. *Id.*

202. *Id.*

Figure 1. “Credit Union and Bank Rates for Selected Financial Product
(National Averages for All Credit Unions and Banks)”²⁰³

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).

Credit unions offer significantly lower rates on small, consumer-type loans, but on other types of credit, deposits, or investments, credit unions and banks offer substantially similar rates.²⁰⁴ Although “more favorable terms and resulting savings cannot be specifically tied to the more favorable tax status afforded credit unions relative to banks,” lower tax liability leads to lower costs for the business and allows the business to make a profit at lower interest rates.²⁰⁵

Credit union membership is growing significantly, having increased by approximately 33 million members from 2010 to 2020—a 35.6 percent increase.²⁰⁶ Annual credit union loan production saw an even bigger boom in that decade, increasing by over \$600 billion from 2010 to 2020—a 104.6 percent increase.²⁰⁷ As credit unions continue to become more popular, provide new services, and offer lower rates, customers of taxable financial institutions will be driven to join credit unions; thereby, increasing tax-exempt revenue and decreasing taxed revenue.

203. MARPLES, *supra* note 25, at 6.

204. *Id.* at 3.

205. *Id.* at 6; see Danielle Smyth, *What Is the Relationship Between Total Revenue Profit & Total Costs?*, CHRON., <https://smallbusiness.chron.com/relationship-between-total-revenue-profit-total-costs-15813.html> [<https://perma.cc/9RTG-V8U6>] (Dec. 8, 2020).

206. CREDIT UNION NAT’L ASS’N, *supra* note 138.

207. *Id.*

2. Fiscal Policy Would Be Greatly Aided by Taxing Credit Unions

In 2018, the Joint Committee on Taxation estimated that the federal coffers would lose \$1.8, \$1.9, \$2.0, \$2.1, and \$2.2 billion respectively in the years 2018 through 2022.²⁰⁸ This foregone revenue, by way of the exemption, is referred to by the Committee as “tax expenditures,” and these tax expenditures are only the lost tax dollars on the estimated actual revenue, the estimates do not consider the costs associated with losing taxable revenue in favor of tax-free revenue.²⁰⁹

Taxing credit union income would not only generate income for the government by collecting taxes from credit unions, but the tax may also increase credit union rates and drive members to other taxed financial institutions.²¹⁰ Customers moving to other financial institutions would raise taxable income at these other institutions, and the tax receipts may be even larger because many customers would move to large institutions, generating income for businesses which are generally in a higher tax bracket.²¹¹ “Thus, removing the federal income tax exemption for credit unions could raise more tax receipts than the estimates here because their behavioral changes would increase the tax base at credit unions or at their competitors”²¹² The double benefit of removing the federal income tax exemption from credit unions could help Congress shrink the ever-increasing budget deficit of this country.

IV. THE CASE FOR KEEPING THE TAX-EXEMPTION

Credit unions have a “specified mission of meeting the credit and savings needs of consumers, especially persons of modest means” and because credit unions have not deviated from that mission, they have been able to retain their tax-exempt status.²¹³ Although credit unions no longer look the exact same as they did a century ago, credit unions still provide a service to the community worthy of a tax exemption.²¹⁴

208. STAFF OF THE JOINT COMM. ON TAX’N, JCX-81-18, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2018-2022, at 25 (2018).

209. *Id.*

210. *See* Tatom, *supra* note 137.

211. *See id.*

212. *Id.*

213. *See* Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified at 12 U.S.C. § 1759).

214. *See Credit Union Tax Exemption: Background, supra* note 6; INTERNAL REVENUE SERV., *supra* note 23.

Credit unions have expanded the meaning of a common bond which has allowed them to serve more people.²¹⁵ Providing low-cost financing to more people does not run against the mission of credit unions.²¹⁶ Further, the relevance of the common bond has diminished greatly since the advent of credit reporting agencies.²¹⁷ Because credit reports are readily available for financial institutions, the need for a meaningful common bond is greatly diminished, so allowing for broader membership is not straying from any meaningful tenet of the credit union mission; it is adaptation.²¹⁸ Although the meaning of common bond has been expanded, it is still necessary to have a common bond of some kind that adheres to the original form of credit unions if a person wants to become a member.²¹⁹

Credit unions have expanded the services available to members. The expanded services do not in any way harm the mission of providing funds to consumers at low costs; instead, they are just another diverse source of revenue for the credit unions to ensure financial viability.²²⁰ Despite the change in products offered, the low-rate consumer loans available to members remain a staple in the credit union portfolio.²²¹ In fact, the NCUA report prepared for the quarter ending September 30, 2021, shows that only 52 percent of credit union loans are mortgages or other real estate loans.²²² Auto loans account for the second biggest portion of credit union loans at 32.5 percent.²²³ In addition to auto loans, which is the main consumer-type loan on credit union balance sheets, credit unions also offer credit cards and other consumer loans to members.²²⁴ In fact, credit unions offer significantly lower rates for auto loans than banks, beating banks by over two percent on both 60-month and 48-month loan rates.²²⁵

The demographics of credit union members have changed over time, but this should not be grounds for removing the tax-exempt status of credit unions. The

215. See MARPLES, *supra* note 25, at 4; 12 U.S.C. § 1759 (1998).

216. See *Credit Union Tax Exemption: Background*, *supra* note 6 (quoting 112 Stat. at 913).

217. MARPLES, *supra* note 25, at 5.

218. See *id.* at 5; *Credit Union Tax Exemption: Background*, *supra* note 6.

219. See § 1759.

220. Frame et al., *supra* note 110, at 2.

221. See OFF. OF EXTERNAL AFFS. & COMMC'NS, INDUSTRY AT A GLANCE (Nat'l Credit Union Admin. 2021), <https://www.ncua.gov/files/publications/analysis/industry-at-a-glance-september-2021.pdf> [<https://perma.cc/8KQR-GW85>].

222. See *id.*

223. *Id.*

224. See *id.*; MARPLES, *supra* note 25, at 6.

225. MARPLES, *supra* note 25, at 6.

mission of credit unions is not to shun the wealthier citizens from membership; in fact, the mission is to provide low-cost financing to help the poor and middle-class.²²⁶ As previously illustrated, credit unions still offer personal loans at rates far lower than banks.²²⁷ Unlike before the advent of credit unions, where poor people were unable to obtain financing without paying usurious interest rates at banks, credit unions offer credit at affordable rates to consumers.²²⁸

Losing tax revenues in favor of promoting credit unions is not a new trade-off. Congress made the decision in 1934 to forego tax revenue from credit unions in an effort to promote affordable consumer financing.²²⁹ Unlike its thrift counterparts, credit unions have not deviated from their mission, so Congress has not removed their exempt status.²³⁰ Instead, Congress has reaffirmed its commitment to the credit union industry by allowing greater product offerings and a wider customer base.²³¹ As recently as 1998, Congress has found that credit unions are still organized and operated according to their original designs and purposes.²³²

Notwithstanding the foregoing reasons for maintaining the tax-exempt status of credit unions, the exemption should be removed. Credit unions not only serve a wider customer base due to the deterioration of the common bond, but they also serve a wealthier customer base.²³³ Similarly, credit unions offer more services than ever before.²³⁴ The limited and poorer customer base, as well as the limited services to be offered, created disadvantages to credit unions which were offset by the tax exemption.²³⁵ These limitations no longer exist or are greatly diminished, so the need for the exemption is significantly lessened. Although credit unions still offer reduced rates for consumer loans, the purpose of credit unions was to offer these preferential rates to lower income customers.²³⁶ The customers of credit

226. See *Credit Union Tax Exemption: Background*, *supra* note 6 (quoting Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified at 12 U.S.C. § 1759)).

227. See *supra* Part III.C.1.

228. See MARPLES, *supra* note 25, at 6; see also BIRCHALL, *supra* note 12, at 6–8.

229. See Federal Credit Union Act, Pub. L. No. 73-467, 48 Stat. 1216, 1218 (1934).

230. INTERNAL REVENUE SERV., *supra* note 23.

231. See 12 U.S.C. § 1759 (1998); Act of Apr. 19, 1977, Pub. L. No. 95-22, 91 Stat. 49.

232. See *Credit Union Tax Exemption: Background*, *supra* note 6 (quoting Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified at 12 U.S.C. § 1759)).

233. See *supra* Part III.A.

234. See *supra* Part III.A.3.

235. See *supra* Part II.B.

236. See *Credit Union Tax Exemption: Background*, *supra* note 6.

unions are now wealthier than the customers at banks, so the lower rates offered at credit unions—enabled by the tax exemption—undercut bank rates, thereby taking business from a taxable institution to a tax-exempt institution.²³⁷ And these advantages can no longer be justified by the original purpose of serving lower income people because the statistics clearly show that credit unions no longer serve a lower income customer base than their banking counterparts.²³⁸

V. CONCLUSION

Credit unions were created with a noble mission in mind, and they offered an important service to the middle-class and low-class citizen.²³⁹ Because of their important mission and unique qualities, credit unions have been tax-exempt since 1934.²⁴⁰ Since 1934, credit unions have undergone significant changes in the breadth of the available customer base, the demographics of membership, and the types of services able to be offered.²⁴¹ Throughout the myriad of changes, a few things have remained constant: Congress remains committed to the tax-exemption and credit unions have continued to offer low-rate personal loans that are affordable for the consumer.²⁴² On the other hand, the significant changes undergone by the credit union industry have made them appear almost indistinguishable from banks in the available customer base and types of services offered by each.²⁴³ Credit union members are also now wealthier than bank customers on average.

Not taxing credit unions violates fundamental tax policy principles.²⁴⁴ Violating the principal of neutrality leads to inefficiency which causes a double negative to tax revenue by driving customers out of taxed institutions towards lower-cost tax exempt credit unions.²⁴⁵ By removing the tax exemption, Congress could greatly help federal revenues as well as return the financial services industry to a level playing field.²⁴⁶ Like the thrifts before 1951, credit unions have deviated from their original mission through great expansion of services and membership;

237. *See supra* Parts III.A.2., III.C.1.

238. *See supra* Part III.A.2.

239. *See supra* Part II.B.

240. *See supra* Part II.B.

241. *See supra* Part III.A.

242. *See supra* Part IV.

243. *See supra* Part III.A.3.

244. *See supra* Part III.C.1.

245. *See supra* Part III.C.1.

246. *See supra* Part III.C.2.

therefore, credit unions should meet the same fate as those thrifts and lose their federal income tax exemption.

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