Research Report

April 2003

106 N. Bronough St. ♦ P. O. Box 10209 ♦ Tallahassee, FL 32302 ♦ (850) 222-5052 ♦ FAX (850) 222-7476

Florida Credit Unions Receive Tax Exemptions Worth $102 Million

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

The change in the credit union industry began in earnest in 1971 with the creation of a federal insurance program for credit unions. The security made credit unions more attractive to consumers. Moreover, by removing the risk to members, the common bond became less important. With the link between depositor and borrower diminished, the need for close association between members was also reduced. This helped lead to a rapidly expanding credit union membership base.

Other changes occurred in 1978 and 1980 when Congress authorized credit unions to offer mortgage loans and transaction accounts. Before this, members tended to use both credit unions and banks. Now credit unions had begun to become full-service financial institutions. Credit unions now offer credit cards, ATMs, money market accounts, mutual funds, home equity lines of credit, discount brokerage services and insurance.

These factors, fueled by tax-exempt status as well, have lead to phenomenal growth of the credit union industry. In 1950, Florida credit unions had 72,000 members, assets of $16 million and loans of $12 million. By 1970, they had grown to 722,000 members, assets of $567 million and loans of $459 million. By 1990, there were 2.6 million members, assets reached $9.7 billion and loans totaled $6 billion. In 2001, the credit union industry in Florida had four million members, assets of $25.6 billion and loans of $16.2 billion.

Credit unions are generally exempt from most taxes. Both state-chartered and federally chartered credit unions are exempt from the federal income tax. Federally chartered credit unions are also exempt from most state and local taxes. The only taxes federal credit unions pay are real and tangible personal property taxes, social security and unemployment compensation taxes.

State credit unions also are exempt from federal income taxes, but they are subject to federal unrelated business income tax. The state and local taxation of state credit unions is largely up to the individual states. Florida law states: "All credit unions now or hereafter chartered under the laws of the state shall have the same immunity from state and local taxation that federally chartered credit unions have from time to time under the statutes of the United States," Section 213.12 (2), *Florida Statutes.* This in effect means that all credit unions in Florida are exempt from all state and local taxes except real and tangible property taxes.

This report estimates the value of the tax exemptions afforded credit unions in Florida. Florida TaxWatch previously estimated these exemptions in a 1997 report (see *An Analysis of the Tax Treatment of Credit Unions,* February 1997.) Using detailed financial information on each individual credit union in the state--gathered by Sheshunoff Information Services, Inc—Florida TaxWatch has developed new estimates for the major credit union state tax exemptions: the corporate income tax, the intangibles tax, the sales tax and the documentary stamp tax. Florida TaxWatch also estimated the value of the exemption from the federal corporate income tax and the local option sales tax available to Florida counties.

Corporate Income Tax. All credit unions in Florida are exempt from both state and federal corporate income taxes. This exemption, particularly the federal one, constitutes the largest exemption afforded credit unions. In a 2001 report, the U.S. Department of the Treasury estimates that, nationwide, the federal income tax exemption alone will be worth $13.7 billion to $16.2 billion to all credit unions over ten years.

To estimate the value of Florida credit unions' exemption from federal and state income taxes, Florida TaxWatch estimated the tax burden for each credit union in the state if they were subject to the same tax as banks and savings associations. Net income (income minus expenses and interest and dividends paid) was used for taxable income. Credit unions were given their reported allowance for loan losses. To allow for possible deductions and credits not reflected in the credit union data, taxable income was reduced by 10%. The tax liability was calculated for each institution and those with negative taxable income (loss) excluded. For the Florida tax, the standard $5,000 deduction was subtracted, and the 5.5% tax rate was applied. Based on these data, credit unions would have had a state income tax liability of approximately $11.4 million in 2001.

For the federal income tax, the applicable tax rate (15%-39%) was applied. This resulted in an estimated federal income liability of $70.0 million. Estimated liability was calculated for each year back to 1996. Over this six-year period, total federal liability ranged from a high of $73.3 million (2000) to a low of $52.5 million (1997). State liability ranged from $11.9 million to $8.6 million.

To check the reasonableness of the estimates, we compared the average credit unions effective tax rate (all corporate income taxes as a percent of net income) to that of Florida-based banks. We used data from the same source, including reported income taxes paid by banks. Only banks and credit unions that had positive net income and paid taxes were included. The credit unions' effective rate was 35.2% while banks had a rate of 35.9%.

Further, a U.S. Treasury report, cited above, estimated the value of the credit union exemption from federal income taxes to be worth $6.1 billion to $6.8 billion over five years. The Florida credit union industry makes up about 5.0% of the industry nationwide (based on assets.) If you apply that percentage to the Treasury estimate, an estimate of Florida's annual federal liability of $61 million to $68 million is derived.

The exact response of credit unions to being taxed is unclear, but it is likely that some would take steps to lower their taxable income. Instead of building credit union capital, members could instead opt for higher dividends, lower loan rates or increased services. Another example, credit unions could alter their investment portfolios to hold more tax-exempt securities in order to lower their tax liability. These effects are included in the lesser Treasury estimate.

		Federal Tax	**State Tax**
Corporate income tax exemption:	State Chartered	$29.5 million	$4.8 million
	Federal Chartered	$40.5 million	$6.6 million
	Total	$70.0 million	$11.4 million

Sales Taxes. The estimate for the value of credit unions' sales tax exemption on purchases they make is based on operating expense categories. The same assumptions as to the portion of taxable sales in individual categories used in the 1997 study were used again. These were developed in consultation with Florida Department of Revenue staff and others. It was estimated that all credit unions in Florida had total taxable purchases of $243 million. This was 28% of total expenses (not including interest, dividends or provisions for loans and investment losses.) This translates into state sales taxes of $14.6 million. Taxing credit unions would also add $3.6 million in local option sales tax capacity for counties (based on the maximum 1.5% tax rate.) Applying the applicable local sales tax rate (0% - 1.5%) to each credit union results in an estimate of the local sates tax exemption of $1.9 million.

		State Tax	**Local Tax**	**Total**
Sales tax exemption:	State Chartered	$7.0 million	$0.9 million	$7.9 million
	Federal Chartered	$7.6 million	$1.0 million	$8.6 million
	Total	$14.6 million	$1.9 million	$16.5 million

Intangibles Tax. Mortgages and other obligations secured by liens on Florida realty are not subject to the annual intangibles tax, but are subject to a non-recurring, two-mill tax due at recordation. Although technically it is a tax on the lender, Florida law allows the tax to be directly passed on to the borrower as is common practice. Since the tax is the responsibility of the lender, and credit unions are exempt, the tax is not collected on mortgages they issue. If taxed, although this would not add to credit unions' direct tax burden, it would produce revenue for the state.

Florida credit unions made $2.4 billion in real estate loans during 2001. Assuming 90% of these loans were secured by liens on Florida realty, credit unions' tax exemption amounts to $4.3 million annually.

Real estate loans are a rapidly growing business for credit unions. Florida credit unions granted an average of $720 million annually in real estate loans from 1992-1995. From 1996 to 2001, these loans more than doubled, averaging $1.5 billion annually and peaking at $2.4 billion in 2001.

		Non-recurring tax (passed on)
Intangibles tax exemption:	State Chartered	$2.2 million
	Federal Chartered	$2.1 million
	Total	$4.3 million

Documentary Stamp Tax. Credit unions are also exempt from documentary stamp taxes on loans when they are the borrower. Although borrowing has been increasing, the vast majority of credit unions do little if any borrowing. Only eleven credit unions reported borrowing in 2001, totaling $365 million. It is difficult to determine the details of the borrowing from the data available. In addition, the Florida Legislature recently enacted a cap of $2,450 per transaction on doc stamps due. It should also be noted that while the credit union may be exempt, if the lender is not, the lender would still be liable for it. So, this exemption is of minor fiscal impact.

Documentary stamp taxes also apply to mortgages and other loans issued by financial institutions. Since this tax can be passed on, doc stamps are collected from the borrower on mortgages and non-open ended loans made by credit unions.

Total Taxes. Credit unions also have exemptions from a few other state and local taxes such as occupational licenses. The value of these would be relatively minor, and this report does not consider them. Based of the estimates discussed above, the total value of tax exemptions afforded Florida credit unions is $102.2 million. Of this amount, $70.0 million are federal taxes, $30.3 million are state taxes and $1.9 million are local taxes.

Estimated Value of Florida Credit Union Tax Exemptions
(Based on 2001 operations. Dollars in millions.)

State		**Federal**	
Income Tax	$11.4	Income Tax	$70.0
Intangibles Tax	$ 4.3		
Sales Tax	$14.6	**Local**	
		Sales Tax	$1.9
Total State Taxes	$30.3	**Total All Taxes**	$102.2

Credit Union Exemption vs. Taxes Paid by a Similar Bank

To demonstrate the difference between taxes paid by similar banks and credit unions, a hypothetical Florida depository institution with assets of $50 million was examined. This institution was created by averaging financial data of ten Florida credit unions with assets ranging from $46 million to $56 million (average of $50 million.)

This institution has taxable income of $214,000, expenditures subject to sales tax of $513,000 and total real estate loans of $3.9 million. None of the ten credit unions in the sample did any borrowing, so documentary stamps taxes were not included in this analysis.

If this institution is a bank or savings association, it would incur a total income tax liability of approximately $78,500, total sales taxes of $35,700 and intangibles taxes of $7,000. **While this bank would pay total taxes of $121,200, if this institution is a credit union, it would pay none of these taxes.**

For Comparison: Taxes Paid by Businesses and Families

To calculate the sales and income tax burden on an “average” Florida family, we used a family of four with total income of $60,000 (approximately the median income for a family that size).

Based on data from the Florida Legislature and the Consumer Expenditure Survey, the average state sales tax burden for a family in that income range is $1,487. Assuming the family lives in a county with a 1% local option sales tax, their total state and local sales tax burden climbs to $1,735.

The estimated federal income tax burden for that family is dependent on whether they itemized deductions or take the standard deduction. Using the 2002 tax code, the standard deduction, personal exemptions and child tax credit would reduced taxable income to $38,950, resulting in tax of $5,246. If that family itemizes, taxable income would be $35,477. This assumes the average deduction—calculated by the IRS—for interest, taxes and charitable contributions taken by a family in that income class (the tax deduction was cut in half since Florida has no state personal income tax). This would result in a tax of $4,721. Taking the midpoint between the two estimates creates a federal income tax estimate for this family of $4,984.

Therefore, this "average" family of four with income of $60,000 would incur sales and federal income taxes of approximately $6,719.

Calculating the taxes paid by a "average" small business is somewhat more speculative. We assume a Chapter C corporation that has sales of approximately one million dollars, expenses of $450,000 and taxable income of $100,000.

According to a study done for the Florida Senate, a typical small business with total expenses of $500,000 has taxable expenses of 35% of that amount. Using that percentage, and assuming the business is located in a county with a 1% local option sales tax, our hypothetical business would have a total sales tax burden of $11,025.

Taxable income of $100,000 would result in a state corporate income liability of $5,225 and federal tax liability of $22,250.

Therefore, this hypothetical business with taxable income of $100,000 would incur total sales and income taxes of approximately $38,500.

Majority of Tax Exemption Value Lies With Relatively Few Credit Unions

Credit unions vary greatly in size, with assets ranging from only $86,000 to almost $3 billion. Although the trend is fewer, but bigger, credit unions through consolidations, most credit unions are still relatively small. Credit unions with assets of under $10 million make up 31% of all credit unions, and 72% have assets of less than $50 million.

Not surprisingly, the larger credit unions comprise the lion's share of the value of the total credit union tax exemption. The top three credit unions, each with assets in excess of $1 billion, comprise one-quarter of the total tax exemption. Credit unions with assets of more than $100 million make-up 21% of all credit unions, but 90% of the tax exemption value.

Asset Level	% of Credit Unions	% of Tax Exemption
1 billion+	1%	25%
500 million+	5%	56%
250 million+	10%	74%
100 million+	21%	90%
50 million+	28%	93%
25 million+	48%	97%

History of Tax Treatment of Credit Union, Mutual Savings Banks and Thrifts

Although the first state credit union was chartered in 1909, the federal tax status of credit unions was not questioned until 1917, when an administrative ruling of the U.S. Attorney General exempted credit unions on the ground that they closely resembled the mutual and cooperative banks and similar institutions that Congress had expressly exempted from tax by legislation enacted in 1913 and 1916. This legal opinion was the basis for the tax exemption until 1951.

There were no federally-chartered credit unions until the 1934 Federal Credit Union Act. The original bill had a tax exemption written into it, but, upon consideration, the House of Representatives struck the exemption from the law. However, in 1935, the Commissioner of Internal Revenue ruled that federal credit unions were tax-exempt. After another attempt to provide a statutory exemption failed in 1936, Congress amended the Federal Credit Union Act in 1937 to exempt federal credit unions from federal and most state and local taxation. Since mutual banks, mutual insurance companies and mutual savings and loans were tax exempt at that time, this provided consistent treatment for credit unions.

The Revenue Act of 1951 extended the tax exemption for federal credit unions to state credit unions as well. **However, it also repealed the tax-exempt status of savings and loans, mutual savings banks and cooperative banks since it considered them to be more and more like other profit-seeking financial institutions.** These institutions had reached a point of "active competition" with taxable institutions. Congress did allow the institutions a very liberal allowance for bad debt reserves that resulted in very low tax liabilities. In 1962, this allowance was changed, resulting in significant increases in taxes paid by thrift institutions.

At the same time it provided credit unions the tax exemption, Congress also designated federal credit unions as federal instrumentalities. If requested by the Treasury, federal credit unions were to act as fiscal agents of the United States, performing services connected with tax collection and being depositories of public funds. This designation exempts federal credit unions from federal unrelated business income taxes and state sales taxes.

Other depository institutions, including banks, also received numerous tax preferences prior to the Tax Reform Act of 1986. Their primary justification was the extensive regulations imposed on depository institutions. These tax preferences lowered the effective federal income tax rate on depository institutions below the average effective tax rate for all businesses.

However, in a move towards a more neutral tax system for all industries, the Tax Reform Act of 1986 curtailed or eliminated many tax preferences for depository institutions. These included the treatment of bad debt reserves, the deduction for interest to carry tax exempt obligations and special rules for net operating losses. As a result, the effective tax rate of depository institutions has risen to approximate that of other businesses.

This more neutral tax treatment of financial institutions has resulted in heightened criticism by some of the tax exemptions provided credit unions. Prior to 1960, credit unions were still small, limited service organizations that drew little attention from competitors. However, as credit unions grew larger and began offering more services, competitors and tax authorities began to take notice. The IRS has questioned -- and even revoked -- the tax-exempt status of several credit unions, usually over the question of common bond. These revocations has been subsequently reversed by IRS or overturned by the courts.

The 1970s and 1980s also saw several attempts to remove the tax exemption for credit unions. It was part of wide-ranging tax exemption repeal legislation before Congress in 1972. Presidents Carter and Reagan also proposed removing the exemption.

Conclusion

Credit unions have evolved over the years. Changes in the industry and the tax exemptions afforded credit unions have fueled phenomenal growth. There are still credit unions that are small, limited service institutions with tight common bonds. However, there is a number of large, full-service credit unions that compete directly with other financial institutions. This was not envisioned when the tax exemption was written into law.

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

Florida TaxWatch, in examining the tax treatment of banks and credit unions, determines that unequal tax treatment has become harder to justify. It is a central tenet of a fair and competitive tax structure that similarly situated entities are taxed similarly.

Deregulation has greatly increased competition between depository institutions and the tax- exempt status of credit unions gives them a competitive advantage by reducing their operating costs and allowing them to offer higher rates of return and lower interest rates. Tax advantages can also help credit unions grow faster than taxable institutions by allowing greater capital accumulation.

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

It must be remembered that the tax-subsidization of the industry benefits credit union members at the expense of tax-paying non-members. Lawmakers should consider the value of tax exemptions and decide if they would be willing to fund a program at that level to produce the same benefits and whether the absence of funding would reduce or eliminate those desired public interests benefits.

Highlights and Fact Sheet

- Using detailed financial information on each individual credit union in the state, Florida TaxWatch has developed new estimates for the major federal, state and local tax exemptions afforded credit unions in Florida.

- The total value of tax exemptions granted Florida credit unions is $102.2 million. Of this amount, $70.0 million are federal taxes, $30.3 million are state taxes and $1.9 million are local taxes. The $30 million in state tax dollars could fund three new schools, pay 1100 first-year teachers, fully serve the 170,000 Healthy Start clients, or add 11,000 elderly to Community Care for the Elderly. The $70 million in federal dollars could enhance homeland security, provide funding to maintain 7,000 miles of highways, serve 10,000 more children in Healthy Start or renew 10,000 low-income housing assistance contracts.

- The exemptions from corporate income taxes are worth $81.4 million annually. Of this amount, $70.0 million are federal taxes and $11.4 million are state taxes.

- The exemption from sales taxes is worth $16.5 million annually. Of this amount, $14.6 million are state taxes and $1.9 million are local taxes.

- The intangibles tax on mortgages and other loans secured by Florida realty, while the responsibility of the lender, is passed on to the borrower. This exemption is worth $4.3 million. While relatively small, real estate lending is a rapidly growing segment of credit union business.

- The U.S. Department of the Treasury estimates that, nationwide, the federal income tax exemption alone is worth $13.7 billion to $16.2 billion to all credit unions over ten years.

- A relatively large small number of credit unions make up the majority of the tax exemption. The top three credit unions, each with assets in excess of $1 billion, comprise one-quarter of the total tax exemption. Credit unions with assets of more than $100 million make-up 21% of all credit unions, but 90% of the tax exemption value.

- An average credit union with assets of $50 million would not pay any income, sales or intangibles taxes. However, if that same institution were a bank, it would pay $121,200 worth of these taxes.

- An “average” family of four with income of $60,000 would incur sales and federal income taxes of approximately $6,719. Similarly, a hypothetical business with taxable income of $100,000 would incur total sales and income taxes of approximately $38,500.

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

- Florida TaxWatch determines that the unequal tax treatment of banks and credit has become harder to justify. It is a central tenet of a fair and competitive tax structure that similarly situated entities are taxed similarly.

This *Research Report* was written by Kurt Wenner, Senior Research Analyst,
under the Direction of Keith G. Baker, Ph.D., Senior Vice President & COO.
Steven L. Evans, Chairman, and Dominic M. Calabro, President and Publisher
Florida TaxWatch Research Institute, Inc.

For a copy of the report, please call:
(850) 222-5052
OR

Write TaxWatch at:
P.O. Box 10209
Tallahassee, FL 32302
OR

Access and download the report at:
www.floridataxwtch.org where this *Research Report* was
initially released before being printed in hardcopy format.

About Florida TaxWatch

Florida TaxWatch is the only statewide organization entirely devoted to protecting and promoting the political and economic freedoms of Floridians as well as the economic prosperity of our state. Since its inception in 1979, Florida TaxWatch has become widely recognized as the watchdog of citizens' hard-earned tax dollars. The nationally distributed *City and State* magazine (now *Governing* magazine) published a poll of the nation's statewide taxpayer research centers. Based on this poll, the publication cited Florida TaxWatch as one of the six most influential and respected government watchdogs and taxpayer research institutes in the nation.

In recent years, news stories about Florida TaxWatch have run in all Florida newspapers, *The Wall Street Journal*, *The New York Times* and *The Washington Post*. In addition, Florida TaxWatch has been featured on the prestigious *MacNeil/Lehrer Newshour.*

Florida TaxWatch is a private, non-profit, non-partisan research institute supported by voluntary, tax-deductible membership contributions and philanthropic foundation grants. Membership is open to any organization or individual interested in helping to make Florida competitive, healthy and economically prosperous by supporting a credible research effort that promotes constructive taxpayer improvements. Members, through their loyal support, help Florida TaxWatch to bring about a more effective, responsive government that is accountable to the citizens it serves.

Florida TaxWatch is supported by all types of taxpayers -- homeowners, small businesses, corporations, professional firms, labor unions, associations, individuals and philanthropic foundations -- representing a wide spectrum of Florida's citizens.

Florida TaxWatch's empirically sound research products recommend productivity enhancements and explain statewide impact of economic and tax and spend policies and practices. Without lobbying, Florida TaxWatch has worked diligently and effectively to build government efficiency and promote responsible, cost-effective improvements that add value and benefit taxpayers. This diligence has yielded impressive results: through the years, three-fourths of TaxWatch's cost-saving recommendations have been implemented, saving taxpayers over $6.2 billion (according to an independent assessment by Florida State University). That translates to approximately $1,067 in added value for every Florida family.

With your help, we will continue our diligence to make certain your tax investments are fair and beneficial to you, the taxpaying customer who supports Florida's government. Florida TaxWatch is ever present to ensure that taxes are equitable, not excessive, that their public benefits and costs are weighed, and that government agencies are more responsive and productive in the use of your hard-earned tax dollars.

The Florida TaxWatch Board of Trustees is responsible for the general direction and oversight of the research institute and safeguarding the independence of the organization's work. In his capacity as chief executive officer, the president is responsible for formulating and coordinating policies, projects, publications and selecting the professional staff. As an independent research institute and taxpayer watchdog, the research findings, conclusions and recommendations of Florida TaxWatch do not necessarily reflect the view of its members, staff or distinguished Board of Trustees.

Florida TaxWatch

106 North Bronough Street
P.O. Box 10209
Tallahassee, FL 32302

NON-PROFIT ORG.

U.S. POSTAGE
PAID

TALLAHASSEE, FL
Permit No. 409