The tax status of credit unions

An issues paper

6 September 2000

Prepared by: *The Treasury*
Ministry of Economic Development
Policy Advice Division of Inland Revenue

The tax status of credit unions: an issues paper

First published in September 2000 by the Policy Advice Division of the Inland Revenue Department, PO Box 2198, Wellington, New Zealand.

ISBN 0-478-10338-7

INTRODUCTION

1. For over a century income derived by credit unions, except for that derived from a business carried on beyond the circle of membership, has been exempt from taxation.

2. In 1989 the Consultative Committee on the Tax Treatment of Life Insurance and Related Areas recommended that income derived by credit unions should be subject to tax. That recommendation was accepted by the Government of the day, but implementation of the recommendation was deferred until a review of the regulatory environment was completed.

3. Taxing the income derived by credit unions would be consistent with the tax treatment of other non-profit bodies who make distributions to members. Those bodies pay tax in the normal way.

4. The regulatory review of credit unions has not been completed, although the deposit limit for credit unions has recently been increased from $40,000 to $250,000. This has raised concerns that the increase could create or extend any competitive advantage associated with the credit union tax exemption. The Government has therefore directed the Treasury and Inland Revenue, in consultation with the Ministry of Economic Development, to report on whether the current exemption is appropriate.

5. In deciding whether the current exemption is appropriate, the Government will need to consider the implications of removing it.

6. This paper addresses issues about the way in which credit unions should be taxed if the exemption were to be removed. It sets out a number of proposals for consideration if this was to be the case.

Submissions

7. Submissions are invited on the proposals in this paper. In particular, we are interested in receiving submissions that deal with issues such as:

- whether it is appropriate to treat credit unions in the same manner for tax purposes as other non-profit bodies who make distributions to members;

- whether or not credit unions' tax exemption leads to a competitive advantage relative to other financial services providers, and if so, the extent of that advantage;

- details of the extent of compliance costs associated with any of the proposals in this paper;

- whether a minimum threshold should be applied so that smaller credit unions are not subject to income tax. If so, should the minimum threshold be based on values of assets, the deposit limit chosen by a particular credit union, or types of common bond?

8. Submissions may be made in electronic form to:

Policy.webmaster@ird.govt.nz

Alternatively, submissions can be addressed to:

Tax Status of Credit Unions
C/o General Manager
Policy Advice Division
Inland Revenue Department
P O Box 2198
WELLINGTON

9. Submissions should contain a brief summary of their main points and recommendations. They should be made by 6 October 2000.

SUMMARY OF PROPOSALS
SET OUT IN THIS ISSUES PAPER

- *Either*:
  - The tax treatment would be determined by the nature of the legal entity carrying on the credit union business; *or*
  - Credit unions could be deemed to be companies (for tax purposes only).
- Credit union dividends would continue to be treated as interest for tax purposes. They would, therefore, be allowed as a deduction to credit unions.
- Section HF 1 of the Income Tax Act 1994 (Profits of mutual associations in respect of transactions with members) would be simplified for credit unions. No apportionment of rebates would be required.
- No deduction would be allowed for amounts transferred to reserves to meet a credit union's reserve asset ratio requirements. However, the requirement that amounts transferred cannot be returned to members would be reviewed.

Ancillary issues

- Assets could be revalued at market value for tax purposes, at the date taxation was imposed.
- Distributions from retained earnings would be treated as interest paid, as they are at the moment.
- If distributions were able to be made from the general reserve, conceptually, these amounts should be treated as interest. However, the tax treatment of these distributions would be considered as part of the review of whether reserved amounts should be able to be repaid to members.
- Continuity of losses and imputation credits would be protected against changes in "shareholding" if credit unions were deemed to be companies.
- The issue of whether taxation should start from a particular date or from the beginning of an income year would be discussed with credit unions.

PART I: BACKGROUND

Current tax treatment

10. Income derived by credit unions, except for that derived from a business carried on beyond the circle of membership, is exempt from income tax.

11. Cases such as *Port Chalmers Waterfront Workers Union v Commissioner of Inland Revenue* [1996] 17 NZTC 12,523 discuss what is meant by "business carried on beyond the circle of its membership". In that case the workers' union received "equity payments" in relation to the proposed introduction of containerisation. The Court of Appeal held that the nature of work involved in securing, maintaining and dealing with the equity payments did not constitute carrying on a business.

12. The court further held that whether investment or other operations amount to carrying on a business is a question of fact and degree turning on the nature, purpose and extent of the activities undertaken. It is, therefore, a matter of fact and degree when determining whether a credit union that deposits money in a bank is carrying on a business beyond the circle of its membership, and consequently whether the interest derived is subject to tax or not.

13. Therefore interest derived by credit unions from non-members is not subject to tax unless the business test is satisfied in relation to that income.

14. Interest paid to members is taxed in the members' hands.

History of the tax exemption

15. The rationale for the exemption is unknown. The exemption applies to both credit unions and friendly societies. Friendly societies have had a tax exemption since the first Tax Act was enacted, in 1891. No records are held on why the exemption was introduced. A possible rationale was recognition of the benevolent nature of friendly societies. Alternatively, at that stage low-income earners were not subject to income tax, making it rational to exempt organisations such as credit unions, the membership of which consisted of low-income earners.

16. Before the enactment of the Friendly Societies and Credit Unions Act 1982 (the FSCU Act) the friendly society movement had operated loan funds within their societies. The statutory recognition given to credit unions in the FSCU Act required those loan funds to be registered as credit unions.

17. The taxation treatment of credit unions was reviewed in 1989 by the Consultative Committee on the Tax Treatment of Life Insurance and Related Areas. The committee recommended that income derived by credit unions should be subject to tax, but it was eventually decided to defer the implementation of the recommendations until the regulatory environment for credit unions was reviewed.

18. In 1995, the Treasury released the discussion paper *Friendly Societies and Credit Unions: Proposed legislative reforms*, on which credit unions and interested parties were invited to make submissions.

19. During September 1998, the Ministry of Commerce released a discussion paper on a proposal to include credit unions under the Companies Act 1993. That proposal, however, was not adopted, and work on alternative regulatory regimes has not yet begun.

20. More recently, the Ministry of Economic Development invited submissions on the proposal to increase the deposit limit for credit unions. The deposit limit has now been increased to $250,000. The current tax review was advanced ahead of the completion of the regulatory review because of concerns about competitive neutrality following the increase.

PART II: COMPETITIVE NEUTRALITY

21. There are two competitive neutrality issues in any discussion of the tax treatment of credit unions:

- whether the tax exemption for credit unions provides a competitive advantage over other financial service providers who do not enjoy such an exemption; and

- whether legislative constraints placed by the FSCU Act on the structure and operations of credit unions disadvantage them relative to other financial service providers who are not subject to the same restrictions.

The tax exemption issue

22. The tax exemption allows credit unions to finance capital growth tax-free because income retained by credit unions is not subject to tax. At the end of the 1997-98 income year, credit unions held general reserves (which cannot be distributed to members for prudential reasons) $21.7 million, other reserves $5.7 million, and retained earnings of $10.2 million. (See appendix.)

23. Other businesses have to finance capital growth from after-tax profits. Hence, if they pay tax at company rates, they have to earn 50 percent more before tax in order to achieve the same outcome as credit unions.

24. The increase in the credit limit, it is argued, could allow credit unions to move beyond their niche market and enter new markets and compete more directly with mainstream financial institutions. That niche market is defined by the requirements that credit unions be member-owned co-operatives that provide savings and loan facilities to their members, along with other statutory constraints on their activities.

25. It is argued that the tax exemption, coupled with an opportunity to expand business as a result of the increased deposit limit, could create a competitive advantage, or increase any existing advantage that credit unions have over other financial service providers.

Constraints imposed by the FSCU Act

26. The FSCU Act, in so far as it applies to credit unions, is very prescriptive. The requirements for credit unions include the following:

- Each credit union must have a common bond of membership, such as locality, occupation or employer. The Registrar of Credit Unions has a very limited discretion to approve an admixture of qualifications.

- Credit unions may borrow only for short terms and for restricted amounts from a registered bank in the form of an overdraft, or from another credit union, friendly society or association of credit unions.

- They have no open market for the application of funds. They may make personal loans only to members. Application of surplus funds is limited to trustee investments. The maximum period of a loan is ten years (secured) and five years (unsecured). Loans to any member may not exceed 10 percent (secured) and 5 percent (unsecured) of the total value of assets of the credit union.

- They must not hold land for investment purposes, and any interest in land from exercising a right under a security must be disposed of within six months.

- They must retain a portion of their income for prudential reasons. Amounts retained for this purpose cannot be paid out to members.

27. One argument is that the potential for credit union growth is limited because of these factors. The opposing argument is that the geographical common bond requirement is artificial, and the increase in the deposit limit will create a significant competitive distortion.

28. Although credit union numbers have been decreasing since the 1980s, numbers of members have been increasing, as has the value of assets. This growth may have implications for the competitive neutrality of these organisations. The appendix outlines the growth of credit unions over the last 30 years and shows aggregate income and expenditure, and aggregate funds and assets of credit unions for the 1997-98 year.

29. Submissions are sought on whether or not credit unions' tax exemption leads to a competitive advantage relative to other financial services providers.

PART III: TAXATION ISSUES

30. In anticipation of the increase in the deposit limit for credit unions from $40,000 to $250,000, the Government asked the Treasury and Inland Revenue, in consultation with the Ministry of Economic Development, to report on the tax status of credit unions. In order to decide whether the current exemption is appropriate, the Government will need to consider the implications for removing it. This part of the paper describes the Government's general direction in tax policy, and considers what an appropriate tax treatment for credit unions would be if the exemption were removed.

31. The Government's revenue strategy was set out clearly in the June 2000 Budget speech:

> "The Government is committed to a broad-based tax system that raises revenue both fairly and efficiently. There is also a commitment to ensure that the business and wider community have certainty about the way in which tax issues will be managed.
>
> To this end the following revenue strategy has been adopted:
>
> To generate the Government's revenue requirements at least possible economic cost, whilst supporting the Government's equity objectives.
>
> This leads to the following tax policy priorities:
>
> - maintaining revenue flows
> - minimising the economic costs of the tax system
> - tax simplification
> - maintaining the integrity of the tax system by encouraging voluntary compliance and reducing avoidance, and
> - maintaining a direct tax system augmented by broadly based indirect taxes."

32. It can be argued that it is inequitable for other non-profit bodies which make distributions to members to be subject to tax on income, while credit unions escape the tax net.

Legal form of credit unions

33. The tax treatment of any taxpayer is generally determined by the legal form through which the business is conducted. Although credit unions have identical legal forms and functions, they are a diverse group that applies different practices in satisfying their individual functions.

34. There are two options for the tax treatment of credit unions. One is for them to remain unincorporated bodies, as they are at present. The other option would be to deem them to be companies – for tax purposes only. Under either option, the calculation of the credit union's taxable income would be the same.

Tax treatment of unincorporated bodies

35. If credit unions were to remain unincorporated bodies their taxable income would be taxed in the hands of the individual organisation. Interest and credit union dividends would generally be deductible to the credit union, and subject to resident withholding tax, the latter being the current tax treatment. A timing difference could occur if interest derived in one year is set aside to be paid out in a subsequent year. In the later year, interest paid by the credit union may exceed interest received, leading to a tax loss being incurred in that year. That loss would be available to set off against income derived in a future year so this would not amount to double taxation. A more flexible approach, however, could be taken if the deemed company option were adopted, because companies have the ability to use an imputation credit account.

36. Unincorporated bodies are generally taxed at individual tax rates. However, the Consultative Committee on the Tax Treatment of Life Insurance and Related Areas recommended that the tax rate applying to credit unions should be the company rate of 33 cents in the dollar.

37. Credit unions with taxable income of less than $38,000 would pay less tax under the individual tax rates than if the company tax rate applied. Those with income in excess of $60,000, however, would be subject to the highest marginal tax rate of 39 cents in the dollar on income above that figure if individual tax rates applied.

Company tax model

38. Income tax is imposed on the taxable income of the company. Distributions of income are taxed in the shareholder's hands as dividends. At present, credit union dividends are deemed to be interest for tax purposes and this is unlikely to change. Credit union dividends would therefore be deductible in calculating the credit union's taxable income, and subject to resident withholding tax.

39. The definition of a "dividend" includes the use by a shareholder of any property of the company, including benefits from the low-interest loans to shareholders. These dividends are referred to as non-cash dividends.

40. Company tax paid can be imputed to dividends distributed to shareholders, ensuring that there is no double taxation. Non-cash dividends can be imputed in the same way as other dividends. If imputation credits are insufficient to cover the shareholders' liability on the dividends, resident withholding tax is payable on the balance.

41. The company tax model provides a more flexible approach where a loss occurs because income of the credit union has been retained and is paid out in a subsequent year. Credit unions could be allowed to elect that some payments to members could be designated as dividends instead of interest. Amounts designated as dividends would not be deductible, thereby reducing any loss that would otherwise have occurred. Tax paid by the credit union in previous years could be used to attach imputation credits to those dividends, ensuring that no further tax was paid by the member.

42. This type of tax treatment is available to statutory producer boards – see sections ME 30 and 31 of the Income Tax Act 1994.

43. Shareholder continuity requirements apply for the purposes of carrying forward imputation credits and losses incurred by the company. Excessive compliance costs can be associated with monitoring these requirements, and special provisions apply for widely-owned companies and the like. If credit unions were deemed to be companies, continuity of imputation credits and losses would be protected.

44. Some distributions are excluded from the definition of a dividend, notably available subscribed capital (ASC). ASC is money contributed to a company by its shareholders. It can be paid to shareholders tax-free if shares are redeemed or repaid. Deposits in credit unions are described in the FSCU Act as shares, but the Income Tax Act 1994 recognises these amounts as loans, and treats dividends paid as interest. If credit unions were deemed to be companies, that treatment should not change. Deposits would not be treated as ASC, but withdrawals of amounts deposited would not be subject to tax. They would be treated, for tax purposes, in the same way as the repayment of a loan, that is, there would be no tax consequences. Any other capital contributed by members could qualify as ASC.

45. The company income tax rate is 33 cents in the dollar.

Mutuality principle

46. The *Report of the Consultative Committee on the Tax Treatment of Life Insurance and Related Areas* recommended that credit unions should be subject to the tax treatment applying to co-operatives (mutual associations). They should have the option to account for all income as if it had been derived from dealings with members, thus avoiding the need for an imputation credit account.

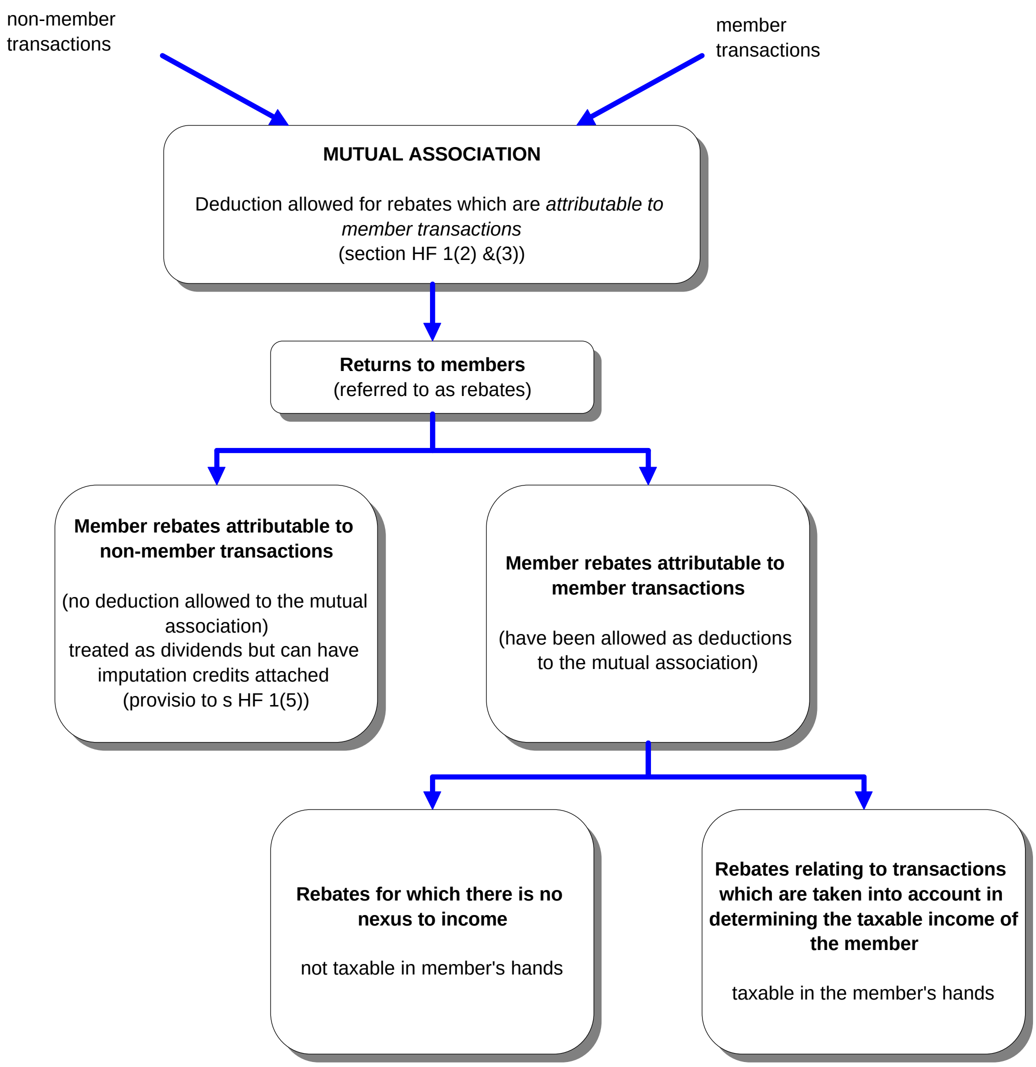
47. The general principle of income tax law known as mutuality starts from the premise that persons cannot make a profit from trading with themselves.

48. Nevertheless, section HF 1 of the Income Tax Act 1994, which applies to co-operatives and other mutual organisations, overrides the mutuality principle in relation to member transactions "where any amounts derived …. would be gross income of the association if the transactions were not of a mutual character". Such amounts derived are treated as gross income for tax purposes.

49. Section HF 1 also allows a deduction for rebates (distributions of profit) relating to member transactions. Any portion of a rebate that is attributable to non-member transactions is not allowed as a deduction.

50. This treatment is based on the recommendations of *Taxation in New Zealand, Report of the Taxation Review Committee*, published in 1967. The committee recommended that profits from non-member transactions as well as retained profits from member transactions should be taxed in the mutual association's hands. The tax treatment of mutual associations is illustrated in figure 1.

FIGURE 1: HOW MUTUAL ASSOCIATIONS ARE TAXED



51. As far as credit unions are concerned, loans to members result in the derivation of interest which would be gross income if the mutuality principle did not apply. Clearly, therefore, if the current exemption were withdrawn, this interest would be subject to tax under section HF 1.

52. Some credit unions deposit reserves with banks and derive interest from those deposits. These transactions would be categorised as non-member transactions and could invoke section HF 1 (2) and (3), which requires the apportionment of rebates between member and non-member transactions.

53. Because credit union interest and dividends are currently treated as interest and subject to tax in members' hands, there is no need to apportion rebates paid by credit unions. It is proposed, therefore, to simplify section HF 1 as it would apply to credit unions, by allowing a deduction for all interest and credit union dividends paid.

Transfers to general reserves

54. The Income Tax Act 1994 provides that expenditure or loss incurred in deriving gross income is an allowable deduction.

55. In previous submissions, credit unions have argued that a deduction should be allowed for amounts transferred to general reserves. They are required to maintain a general reserve for prudential reasons. The current minimum reserve asset ratio is 5 percent of total assets, although this is to increase to 10 percent shortly as a result of the withdrawal of an exemption under the Securities Act 1978.

56. The Income Tax Act 1994 contains no provision that would allow a deduction for these transfers because they are not an expenditure or loss.

57. New Zealand banks are subject to minimum capital requirements which, in some ways, are similar in nature to credit unions' reserve asset ratios. New Zealand incorporated banks must at all times meet the following minimum requirements:

- Capital of the banking group must not be less than 8 percent of the banking group's risk weighted exposures.

- Tier one capital of the banking group must not be less than 4 percent of the banking group's risk weighted exposures.

- Capital of the banking group must not be less than $NZ 15 million.

58. Capital can include shares as well as revenue and similar reserves. Where banks are required to retain reserves to satisfy the minimum capital requirements, no deductions are allowed for this for tax purposes.

59. Accordingly, it would be inequitable to allow credit unions to claim a deduction for transfers to the general reserve for tax purposes.

60. The main concern of credit unions in this area appears to be that amounts transferred to the general reserve cannot be distributed to members or reduced, even if total assets of the credit union are reduced. Upon the winding up of a credit union, the balance in the general reserve must be transferred to another credit union, or applied for charitable purposes. The *Credit Unions Review: Discussion Paper*, published by the Ministry of Commerce in September 1998, said that if an independent trustee model were adopted for credit unions, the existing controls under the FSCU Act on lending, borrowing, reserve requirements, and investing could be removed.

61. As the changes under the Securities Act constitute the adoption of an independent trustee, the rules relating to the general reserve in the FSCU would be reviewed if income of credit unions become subject to tax.

Minimum threshold

62. There is a trade-off in the tax system between revenue and compliance costs. In some cases collecting the correct amount of tax can impose excessive compliance costs on taxpayers. In this situation, a minimum threshold may reduce compliance costs relative to small amounts of income, while the overall effect on tax collections is minimal. One example of a minimum threshold in the Income Tax Act is the deduction of $1,000 that applies to non-profit bodies who do not make distributions to members.

63. There are a number of disadvantages attached to a minimum threshold, however. These disadvantages are:

- They can create a precedent for other small businesses to claim a tax exemption.
- Pressure can be applied to the Government for increases in the level of the threshold.
- They can create an incentive for credit unions to limit their activities in order to maintain the tax exemption.

64. Nevertheless, because there is concern about the effect of taxing the income of smaller credit unions, this paper invites submissions on the feasibility of establishing a minimum threshold. Over the years it has been suggested that this should apply to credit unions which:

- have assets of less than a certain amount;
- elect to maintain the deposit limit at the current level of $40,000;
- have a common bond based on an industry group.

PART IV: ANCILLARY ISSUES

Valuation of assets

65. The Association of Manchester Unity Credit Unions argues that, for tax purposes, assets should be valued at market value at the date taxation begins.

66. Under other reforms, when non-taxable entities have become subject to tax on income derived, assets have been valued according to market value. We can see no objection to this suggestion, although it may impose compliance costs on credit unions.

Distributions from retained earnings

67. The Association of Manchester Unity Credit Unions argues that distributions from retained earnings should be tax-free. These distributions are treated as interest for tax purposes, and this tax treatment should continue.

Distributions from general reserve

68. It has been submitted that distributions from the general reserve should not be subject to tax. Conceptually, these distributions are interest.

69. If tax were to be imposed on income derived by credit unions, however, there would need to be a review of the rules in the FSCU that relate to the general reserve. This issue would be considered as part of that review.

Continuity of losses and imputation credits

70. In relation to the regulatory review, the New Zealand Association of Credit Unions submitted that credit unions should be included within the definition of "special corporate entity" for tax purposes. This would protect the continuity of tax losses and imputation credits. This issue would arise only if the option to deem credit unions to be companies were adopted (or if any credit unions incorporate as companies).

71. It is anticipated that legislation would be introduced to protect continuity for credit unions. However, it is unclear at this stage whether including credit unions within the definition of "special corporate entity" is the best way to do this. It will be necessary for further work to be undertaken in this area if credit unions are eventually deemed to be companies.

Commencement date

72. The New Zealand Association of Credit Unions also noted that if tax is to be imposed, it should apply from a particular date, not from the beginning of an income year. It considers that this is the fairest option. The disadvantage of the income year basis is that credit unions with early balance dates may be taxed up to six months before their standard balance date counterparts and up to twelve months before credit unions using late balance dates.

73. This is an issue which will need to be explored with other credit unions, and submissions would be welcome on this point.

GROWTH OF CREDIT UNIONS 1970 - 99

Year	**Number of credit unions**	**Number of members**	**Total assets** $(000)
1970	107	18,215	13,130
1975	168	58,878	27,274
1980	273	103,109	54,330
1981	290	106,386	54,330
1982	284	109,701	68,890
1983	286	110,236	78,446
1984	295	112,757	93,514
1985	312	138,748	102,744
1986	310	142,034	117,921
1987	268	140,519	138,284
1988	235	139,883	167,792
1989	217	151,957	221,947
1990	210	153,584	245,290
1991	196	158,485	265,819
1992	188	161,996	289,315
1993	177	171,644	317,322
1994	160	179,714	335,999
1995	149	184,088	353,294
1996	119	184,791	363,014
1997	114	185,851	384,864
1998	103	186,675	408,225
1999	98	Figures not available	Figures not available

Source: Report of the Registrar of Friendly Societies and Credit Unions for the year ended 30 June 1999

AGGREGATE INCOME AND EXPENDITURE OF CREDIT UNIONS

(for the 1997/98 year)

	$(000)
Income	
Interest charged on loans to members	35,440
Interest and dividends on investments and accounts	6,324
Rents	233
Fees	3,254
Recovery of bad and doubtful loans	308
Other income	1,056
Total Income	46,615
Administration costs	
Honoria	85
Expenses of officers	145
Remuneration of employees	9,140
Expenses incurred on property	636
Depreciation of properties	186
Depreciation of fixed assets	1,269
Bad loans written-off	1,178
Provision for doubtful loans	1,319
Dues to associations of credit unions	879
Loan/savings protection insurance premiums	845
Other administrative costs	9,420
Other expenses	2,407
Total administrative costs	27,509
Cost of funds	
Interest paid or payable to members	10,148
Dividends paid or payable to members	7,333
Total cost of funds	17,481
Excess income over expenditure	**1,625**
Transfers from income	
Transfer to general reserve	1,553
Transfer to other reserves	532
Transfers from reserves	- 1,272
Net transfers from income	813
Retained earnings at beginning of year	9,440
Retained earnings at end of year	10,248

Source: Report of the Registrar of Friendly Societies and Credit Unions for the year ended 30 June 1999

AGGREGATE FUNDS AND ASSETS OF CREDIT UNIONS
(for the 1997/98 year – includes the two credit union associations)

	$(000)
Funds	
On-call shares	223,137
Term shares	102,913
General reserves	21,787
Other reserves	5,775
Retained earnings	10,248
Bank loans and overdrafts	100
Provision for interest and dividend	2.034
Sundry creditors	5,251
Other liabilities	36,980
Total funds	408,225
Assets	
Land and buildings	6,034
Other fixed assets	5,339
Loans to members	290,351
Government securities	4,010
Local authority and SOE securities	4,410
Bank deposits (incl current account)	63,331
Other investments	26,935
Cash	2,816
Sundry debtors	2,266
Other assets	2,733
Total assets	408,225

Source: Report of the Registrar of Friendly Societies and Credit Unions for the year ended 30 June 1999