



CUNA Issue Summary

UNRELATED BUSINESS INCOME TAX (UBIT)

ISSUE: All credit unions are exempt from the federal corporate income tax under §501(c)(1) of the Internal Revenue Code for federally-chartered credit unions and under §501(c)(14)(A) for state-chartered credit unions. However, income from state-chartered credit unions that the Internal Revenue Service (IRS) deems to be unrelated to the credit union's tax exempt purpose is subject to taxation under §511-513.

Income that is subject to UBIT is defined as any net income derived from any "unrelated trade or business" – defined as "activity not substantially related to organization's exempt purpose." Income is "substantially related" if it "contributes importantly to accomplishment of the organization's exempt purposes." UBIT was designed to prevent unfair market competition by tax-exempt entities and taxpaying for-profit entities.

The IRS requires that state-chartered credit unions file annual Form 990s, like most other tax-exempt entities. These credit unions must also file a Form 990-T (UBIT Form) if the tax-exempt entity has unrelated business taxable income to report.

Credit unions' "exempt purposes" include promoting thrift, creating a source of credit, mutuality and member service. Recently, the IRS has taken an aggressive approach to state-chartered credit union products that it believes should be subject to UBIT. This is in contrast to IRS private letters in the 1970s to credit unions stating that income from credit insurance was not taxable. In 2007, the IRS audited credit unions in Alabama, Connecticut, and Colorado. The IRS questioned whether income from the following sources was substantially related to the credit union's exempt purposes:

- Credit life and disability insurance
- Sale of checks
- Collateral protection and GAP insurance
- AD&D, group life, health and cancer insurance
- Non-member ATM fees
- Debt-financed income
- Interchange fees

In March of 2007, the IRS ruled that several financial products sold by several state-chartered credit unions were subject to UBIT. The state-chartered credit unions were ordered to pay tax on the sale of accidental death and dismemberment insurance, dental and cancer insurance, car warranties, guaranteed auto protection insurance, credit disability insurance and car-buying services. However, the IRS did acknowledge that net income from the sale of checks and from collateral protection insurance was not subject to UBIT.

The banker lobby has been aggressive in urging the IRS to consider various credit union products as subject to UBIT. On February 8, 2007, the American Bankers Association (ABA) sent a letter to the IRS saying that UBIT should apply to state credit union “nonmember business loans.” On February 26, 2007, CUNA’s UBIT Steering Committee responded to the IRS addressing the ABA’s letter. CUNA responded that credit unions generally may make loans, including loans for business purposes, only to their members. Contrary to what the ABA implied in its letter, the credit unions identified in the attachment did not make such loans to nonmembers. However, they may, and do, purchase participation interests in loans made by other credit unions, which originated the loans to their members. The *Federal Credit Union Act* specifically authorizes federal credit unions (FCUs) to buy and sell participation interests in loans (12 U.S.C. Sec. 1757a(a)). Through “parity” provisions or express grants of authority, many state statutes do the same for state credit unions. Participations are fractional interests in loans. The income generated by these loans consists of interest paid by the original borrower on the underlying obligation. The originating credit union generally collects this interest as part of its ongoing obligation to service the loan and passes it through, on a pro rata basis, to the credit unions that have purchased participation interests in the loan. In other words, the income on these loans retains its character as “interest” throughout the process, and is never treated as anything other than interest income to the participating credit unions. Section 512(b)(1) of the Internal Revenue Code excludes “all ... interest” from the definition of unrelated business income.

This statutory provision is reinforced in Treas. Reg. Sec. 1.512(b)-1(a), which states that “[i]nterest ... shall be excluded in computing unrelated business taxable income.” The complete exclusion of interest income (along with dividends, annuities, and certain other types of investment income described in section 512(b)(1)) from the calculation of unrelated business income is not subject to any limitation in terms of whether the income is or is not related to the exempt purpose of the institution receiving it. In other words, interest income, by statute, is entirely excluded from UBIT without regard to whether it is “substantially related” to the exempt purposes of the organization receiving the interest.

Reg. Sec. 1.512(b)-1 states that “all the facts and circumstances” are reviewed in order to determine whether a particular item of income constitutes “interest” excluded from UBIT. In this case, as explained above, the income from loan participation interests always retains its character as interest on a loan, and is never treated as anything else. All facts and circumstances here are consistent with loan participation income being “interest” excluded from unrelated business income, and are not consistent with its being any other kind of income.

On May 31, 2007, the ABA again wrote the IRS regarding the application of UBIT to credit unions. The ABA urged the IRS to include general guidance on the application of UBIT of state-chartered credit unions on the IRS’s 2007-2008 Guidance Priority List. On July 24, 2007, the House Ways and Means Committee Oversight Subcommittee held a hearing on tax-exempt charitable organizations. The ABA submitted a comment letter to the Subcommittee on August 7, 2007, urging the panel to legislate the expansion of UBIT on state-chartered credit unions and to direct IRS to mandate individual Form 990 disclosures for all credit unions and disallow group 990 filings. On August 13, 2007, the ABA sent a follow-up letter to the IRS urging the application of UBIT to additional credit union products and services. On September 5, 2007, CUNA sent a letter to the IRS in response to the ABA letter. The letter refuted ABA charges and suggested a review of S Corporation banks, which are largely exempt from the federal corporate income tax.

CUNA POSITION: State-chartered credit unions began in the United States in 1909, before there was any federal income tax, and today represent about 40% of the country's 8,200 credit unions. The purposes of these credit unions have always been defined by state law and vary from state to state. But those purposes can be boiled down to this: state-chartered credit unions are intended to promote thrift and provide a source of credit to their members on a cooperative, not-for-profit basis. State-chartered credit unions have served this purpose non-stop through the present. In 1917, the U.S. Attorney General opined that credit unions were exempt from the new income tax, and in 1951, Congress codified that exemption even as it revoked the exemption for mutual savings banks. In 1934, credit unions formed an insurance company, CUNA Mutual Group, concurrently with Congress's passage of the Federal Credit Union Act and the establishment of the first federal credit unions. Insurance products have been offered by both federal and state-chartered credit unions ever since -- a history totally different from the decades-long turf battles between the banking and insurance industries. Congress was presumably well aware of this when it codified the exemption for state-chartered credit unions in 1951.

In the 1970s, Congress adopted the Unrelated Business Income Tax ("UBIT") for tax-exempt organizations. It provides that certain income that is not substantially related to the tax-exempt purpose of such organizations is subject to corporate income tax. Over the years, individual state-chartered credit unions were occasionally audited by the IRS for unrelated business income taxes (UBIT), but the IRS provided no guidance to credit unions or its field staff beyond three private letter rulings in the 1970's that said certain insurance products sold by credit unions were exempt from UBIT.

The IRS issued one "technical advice memorandum" (TAM) to one field examiner in 1995, applicable to one credit union, contradicting the earlier letter rulings. That TAM stated that the credit union's income from credit life and credit disability insurance was subject to UBIT. The credit union movement requested a more considered letter ruling on this subject in 1997, but the IRS has never responded to that request. No other audits of credit unions apparently took place until IRS field staff started auditing several dozen credit unions in two states in 2001. The IRS field staff requested that the national IRS office provide guidance on what credit union products and services are subject to UBIT. None of these audited credit unions at this point has paid any UBIT.

In 2003, credit union representatives urged the IRS to issue a revenue ruling on UBIT to provide a more orderly, systemic approach to addressing the application of UBIT to credit union products and services. However, the IRS has chosen instead to issue individual TAMs, which provides less clear guidance to the credit union movement as a whole. Each TAM states that it may not be considered a precedent.

The TAMs issued by early 2007 focused primarily on insurance products and concluded they were outside the purpose of the federal tax exemption for state-chartered credit unions, although not necessarily outside the purpose of the credit unions themselves. They DID NOT conclude that credit unions had strayed from their mission or done anything illegal or improper.

However, the IRS declined to look at the purposes of state-chartered credit unions as defined by the state legislatures that created these credit unions. In addition, the IRS did not take into account the unique decades-long history of insurance product offerings at credit unions, as contrasted with banks. Finally, the IRS did not examine the legislative history of the 1951 tax legislation or what the state of the credit union industry was at that time.

The IRS reasoning in these instances is incorrect because defining the tax-exempt purpose of a credit union is crucial in determining the application of UBIT. The IRS reasoning in the TAMs was incomplete at best. For instance, the IRS concluded that the income from the sale of credit life and credit disability insurance to members who were obtaining loans was unrelated to the purpose of a credit union because the purchase of the insurance was not required for loan approval and was not necessarily available on all loans. The credit union is the beneficiary of the loan in the case of death or disability. A basic purpose of a credit union is to make loans – and to be repaid so that other loans can be made. In addition, such insurance is only available when purchased from the institution making the loan. Such insurance products have been offered by credit unions since the 1930's.

The offering of insurance products by credit unions does not represent any expansion of credit union activities. Insurance products have been integrated into credit union offerings for at least 73 years. The IRS has a long history of faulty reasoning and self-contradiction on credit union issues. In the 1970s, the IRS attempted to revoke the tax exemption of the first credit union established in the United States because it had started offering the equivalent of checking accounts. The IRS was challenged in federal court and lost. As noted, in the 1970s the IRS said that some of the same products at issue in the TAMs were indeed exempt from UBIT.

STATUS/OUTLOOK: In response to IRS actions to impose UBIT on numerous credit union products and services, Community First Credit Union in Appleton, Wisconsin, filed a suit in federal court on January 15, 2008. The complaint specifically challenged the IRS over its application of UBIT to credit life and credit disability insurance, and guaranteed auto protection (GAP) insurance. A second lawsuit was filed against the IRS on May 21, 2008, by Bellco Credit Union of Greenwood Village, Colorado. According to the complaint, Bellco sought a refund of about \$199,000 based on UBIT taxes paid for tax years 2000, 2001, and 2003. The refund claim was based on income generated primarily through sales of credit life and credit disability insurance over those three tax years. Revenue generated from sales of accidental death and disability insurance, and the credit union's involvement with CFS Member Financial Services, a credit union service organization, were included under the 2003 refund claim. The lawsuit contended that the revenue is "substantially" or otherwise related to the exempt purposes and functions of the credit union as a tax-exempt, state-chartered credit union. As a result, the credit union has asserted, no portion of the taxes paid were legally due.

On May 14, 2009, a jury in federal court rendered a verdict squarely in favor of credit unions at the conclusion of the week-long trial UBIT case brought by Community First Credit Union. The ruling means that Community First Credit Union's revenue from the sale of credit life insurance, credit disability insurance and guaranteed asset protection (GAP) will not be taxed under UBIT. On July 14, 2009, U.S. District Judge William Griesbach rejected a Department of Justice motion which sought to overturn the jury verdict.

In early August of 2009, the IRS released a new Technical Advice Memorandum (TAM) stating that income derived by state-chartered credit unions from shared-branching arrangements, management services to other credit unions, certain CUSOs, and sales of financial management services and certain insurance products are subject to unrelated business income tax (UBIT).

CUNA believes that this decision is clearly erroneous on multiple levels. Most basically, it fails to recognize the cooperative, interdependent nature of the credit union system as reflected in shared branching and management of one credit union by another. In addition, the new TAM does not sufficiently analyze whether particular functions of credit union service organizations further the purposes of credit unions, which "should be the test of tax exemption".

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LAST UPDATED: August 14, 2009

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