Bank taxes support the community. *What about credit unions?*

Sub S Banks vs. Credit Unions: An Unfair CU Tax Advantage

Exposing the Credit Union Myth About Subchapter S

Credit unions prefer not to talk about their industry's multi-billion-dollar federal and state income tax exemptions. Instead, to avoid closer scrutiny by policymakers over the repeal of unnecessary subsidies, credit union representatives try to steer the discussion toward the tax treatment of Subchapter S banks.[1] Their claim: Sub S banks have the same tax benefits as credit unions. Nothing is further from the truth.

Banks' Earnings Are Always Taxed—Not So For Credit Unions

A critical distinction between Subchapter S banks and credit unions is that a bank's shareholders are still required to pay taxes on Subchapter S earnings whether or not those earnings are distributed (paid out through dividends or capital gains). Credit unions can avoid taxation by retaining their earnings, meaning their earnings don't go to the members, but are used to grow the institution. The potential tax revenue from credit unions' income, then, is lost forever.

Take, for example, a Subchapter S bank with $1 million of retained earnings. The shareholders could pay close to $400,000 in income taxes. The tax liability for a comparable credit union with $1 million in retained earnings would be $0.

For the Subchapter S bank, there is also a looming double tax. The built-in gain income from the disposition of certain assets and excess passive investment income is taxed twice – once at the corporate level and again as a tax on individual shareholders. Not so for credit unions.

Another important distinction: Every one of the more than 7,000 credit unions is eligible for tax-exempt status – regardless of how big they are or how much they offer bank-like products. In contrast, Sub S institutions are under complex and restrictive IRS rules and only about 2,333 mostly smaller, community banks have elected this structure. Again, the balance is skewed in favor of tax-advantaged credit unions. Comparing the two is like comparing apples to oranges.

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1. Subchapter S of the Internal Revenue Code allows eligible small businesses to obtain tax benefits equivalent to those of a partnership while being allowed to take advantage of the limited liability aspects of the corporate structure. All earnings are subject to current taxation at the shareholder level whether or not those earnings are distributed. Unlike a clear-cut income tax exemption, the eligibility rules under the Subchapter S regime include significant restrictions, such as limits on the number and type of shareholders, that have the effect of limiting the number of banking institutions eligible for subchapter S status.

Banks as Good Corporate Citizens

Subchapter S banks are typically smaller, serving local communities. As good corporate citizens, their taxes on earnings help build healthy, viable communities by paying for such things as improved schools, more teachers, better roads and more police and fire fighters.

Credit unions, on the other hand, enjoy tremendous growth while often avoiding contributing to the tax base integral to maintaining these community services. And as the credit union industry continues to grow at the expense of non-subsidized private-sector competitors, more and more dollars flow away from supporting these essential community services. Does this make sense when federal, state and local governments face rising budget deficits?

Subchapter S Status Can't Compare to CUs' Tax Exemption

It is no secret that many modern credit unions, particularly those that have sought to aggresively expand their product base and membership rolls, are indistinguishable from banks in terms of the products and services they offer and the population base they serve – which makes federal and state income tax exemptions hard to justify. In essence, they have become nothing more than "tax-exempt banks." The tax exemption – and the government subsidy it represents – drives aggressive growth of many credit unions, and crowds out their community bank tax paying competitors. And with that growth comes an ever-expanding tax subsidy.

Subchapter S banks simply cannot compete with this powerful – and growing – credit union tax exemption.

Why Not Let Credit Unions Adopt Something Like Subchapter S Status?

If Subchapter S is such a boon for eligible banks, maybe credit unions should adopt a similar approach to taxation. Traditional tax methods such as Subchapter S, cooperative, limited liability company or partnership taxation ensure that taxes are paid on earnings while minimizing anti-competitive market effects. The credit union federal tax exemption doesn't do that. Subchapter S banks and thrifts pay their fair share of the tax burden. Credit unions do not. By adopting Subchapter S or a similar form of taxation, these previously tax-exempt institutions would join tax-paying institutions in strengthening America's communities. What could be fairer?

Taxation of S Corporations vs. Tax-Exempt Status of Credit Unions

	Subchapter S Bank	Credit Union
Corporate-Level Taxes	Pays taxes on excess passive income and built-in gains income	No taxes paid
Retained Earnings	Shareholders pay taxes on income – whether distributed in dividends or not	No taxes paid
Interest Income	Bank customers pay taxes on interest paid	Same as Subchapter S Banks