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STATEMENT FOR THE RECORD

OF THE

CREDIT UNION NATIONAL ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

HOUSE WAYS AND MEANS COMMITTEE

ON

"S CORPORATION REFORMS"

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The Credit Union National Association (CUNA) is pleased to provide comments for the record in connection with the June 19, 2003 hearing of the Select Revenue Measures Subcommittee of the House Committee on Ways and Means on "S Corporation Reforms" and commends Chairman Jim McCrery (R-LA) and Ranking Member Michael McNulty (D-NY) for their insightful leadership in holding these hearings.

CUNA represents over 90 percent of the nation's approximately 10,400 state and federally chartered credit unions and their 83 million members.

Subchapter S of the Internal Revenue Code was first enacted in 1958 to reduce the impact of federal taxation on small business corporations' choice of business structure and to eliminate the corporate level of tax for such entities. Banks were first allowed to elect Subchapter S status in the Small Business Job Protection Act of 1996. Since that time approximately 1,900 banks have elected Subchapter S status.

The proposed legislation, H.R. 714, the "Small Business and Financial Institutions Tax Relief Act of 2003," introduced by Representative Scott McInnis (R-CO); H.R. 1498, the "Small Business Opportunity and Growth Act of 2003," introduced by Representative Jim Ramstad; and H.R. 1896, the "Subchapter S Modernization Act of 2003," introduced by Representative E. Clay Shaw, Jr., (R-FL), would significantly expand and enhance Subchapter S benefits for the banking industry. In this connection, we note the industry's longstanding lobbying effort to enact such S Corporation

legislation[1]. Incongruously, while aggressively lobbying to increase the tax advantages of Subchapter S for banks, the banking industry also continues to actively lobby to impose additional taxes on credit unions,[2] arguing that credit unions' income tax status provides a competitive advantage and that imposing additional taxes would "level the playing field."

In introducing the Senate version of the "Small Business and Financial Institutions Tax Relief Act of 2003", S. 850, Senator Wayne Allard (R-CO) said he would rather level the playing field by reducing taxes and regulation on other financial institutions. To that end, he reintroduced legislation that would raise the maximum allowable number of S corporation shareholders and thus make it easier for banks to switch to tax-advantaged S corporation status. He observed that his bill would "reduce the tax burden on community banks by permitting the smaller institutions to more easily convert to small-business corporations known as Subchapter S corporations." He also said "Some voices are calling for the taxation of credit unions. I oppose it. Credit unions are not-for-profit businesses and should not be taxed." [3]

CUNA has no objection to financial institutions reducing their tax burden and believes any savings should be passed along to customers. However, we feel compelled to point out the duplicity of the banking industry position. Recent attempts in at least six states to impose additional taxes on credit unions focus on budget deficits and the revenue cost of the credit union income tax exemption. By contrast, CUNA estimates that the direct cost to the U.S. Treasury of the elimination of double taxation under bank Subchapter S election amounted to a record $593 million in foregone taxes in 2001 and $2.1 billion over the past five years. These figures are adjusted for the fact that Subchapter S bank shareholders receive higher dividends (and consequently pay more taxes) than they would if their institutions had not opted for formation under Subchapter S.

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[1] Subchapter S bank legislation was first introduced in the 106th Congress, *The Small Business and Financial Institutions Tax Relief Act of 1999*, H.R. 1638, and 1994, by Representatives Scott McInnis (R-CO), Jim McCrery (R-LA) and J.D. Hayworth (R-AZ), and S. 875, by Senator Wayne Allard (R-CO).

[2] Most recently State bank associations have initiated a coordinated lobbying effort to impose additional taxes on state chartered credit unions. See, e.g., California State Bills AB 1226 and SB 901; Iowa State Bills HF 388, SF 242 and HSB 293; New Mexico State Bill HM 29; Oregon State Bill HB 3491; and Utah State Bill 162.

[3] Credit unions are not-for-profit financial cooperatives, serving members who share something in common: employment, association membership, or residence in a particular geographic area. Members elect credit union boards of directors; each member has an equal vote, regardless of how much he or she has on deposit. Only members may serve as directors, and the vast majority of directors serve without remuneration. Presently, more than 129,000 Americans volunteer for their credit unions. More than 82 million U.S. consumers are member-owners of, and receive all or part of their financial services from the nation's 10,120 credit unions. Of these, 17% rely on credit unions for all of their financial services; 36%, while also using other financial institutions, primarily use credit unions; and 47% are credit union members who primarily use other financial institutions. (Source: Federal Reserve *Survey of Consumer Finances, 1998*).

If recent growth rates continue, the total foregone tax revenue due to Subchapter S election by banks will amount to approximately $13.5 billion over the next 10 years. By 2006, the annual foregone tax revenue from Sub S banks will exceed the foregone revenue from the credit union tax treatment.

Further, a detailed examination of Subchapter S bank financial results for 2001 shows that these banks charged depositor fees that were a bit higher than the fees charged by other small (and some large) banks. At the same time they recorded earnings (ROA) that ranged as much as two times higher than peer commercial banks. For example, the Subchapter S bank average ROA was 1.69% for the year while non-Subchapter S banks with less than $100 million in assets earned 0.79% and non-subchapter S banks with less than $1 billion in assets earned 1.05%. Subchapter S bank cash dividends as a percent of assets averaged as much as 2.5 times higher than those at peer banks.

Recent statements by banking industry lobbyists made in connection with the President's dividend proposal suggest that the primary motivation for industry efforts in expanding Subchapter S is maximizing the amount of dividends to be paid to shareholders (and not to generate more competitive rates and lower fees for customers).[4] These comments tend to belie the earlier claims that the bankers are disadvantaged in providing quality lower cost services to their customers. We believe any such savings should be passed along to customers in the form of more competitive rates and fees. So, while the bankers complain that credit union tax status deprives them of a level playing field, the evidence suggests that a major reason for their competitive issues lies with their failure to pass their tax savings along to their customers in the form of more competitive pricing.

Finally, we note that the banking industry is aggressively pursuing additional tax advantages. H.R.1375, the "Financial Services Regulatory Relief Act of 2003" contains provisions that would permit the Comptroller of the Currency to issue regulations or orders permitting individual directors of national banks that are S corporations to hold subordinated debt of the bank in the amount of $1,000 or more in lieu of stock in the corporation.[5] The bill also would authorize the Comptroller of the

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[4] In this connection, several bankers and the American Bankers Association's Senior Tax Counsel and Director of the group's center for community bank tax indicated banks would be less inclined to pursue S-Corporation status and that banks and thrifts that currently have it might convert back to a typical corporate structure if the President's original dividend proposal had become law. "The primary motivation for electing Subchapter S is to avoid taxation at the corporate level, but this gets rid of it at the individual level. I think if this passes bankers will be saying 'Why deal with the ridiculousness of the subchapter S laws?" *American Banker*, p.1, *January 14, 2003.* Interestingly, in a later Letter to the Editor, a tax attorney-commentator observed the article "left the impression that banks should reconsider whether S status is preferable to C status." The attorney pointed out that even if the President's dividend tax proposal were enacted "The well-informed thoughtful decision will be to remain an S corporation or make an S election as soon as possible. The benefits of being taxed as an S corporation far outweigh the disadvantages." He then enumerated eight such benefits. *American Banker, January 17, 2003*.

[5] Section 101, National Bank Directors.

Currency to prescribe regulations that would allow national banks to organize as limited liability companies (LLCs).[6] In this connection, the Federal Deposit Insurance Corporation (FDIC) has recently adopted a final rule granting deposit insurance to a State bank chartered as a limited liability company (LLC). The Internal Revenue Service has not yet authorized bank LLCs. However, if the remaining restrictions on the establishment of Bank-LLCs are removed, the number of banks that would be organized as LLCs could dwarf the number of Subchapter S banks – and banks would reap even greater tax benefits that the substantial ones already afforded under current law.

We commend your efforts to reduce taxation of financial institutions and to promote increased savings. We recommend that Congress monitor these tax-advantaged banks to determine the amount of advantage passed along to customers in the form of more competitive rates and fees. Thank you for considering our views.

[6]Section 110, Business Organization Flexibility for National Banks.