

**The *Community First Credit Union* Case Is “Substantial Authority”
For Credit Unions to Treat Credit Life & Disability Insurance and GAP Coverage
As Exempt from UBIT on Form 990-T**

IMPORTANT NOTE

Decisions about tax return positions and other tax and financial matters must be made by each individual credit union, based on its specific circumstances, in consultation with its own legal, tax and accounting advisors. This memorandum provides general information only. A credit union should take action on the information provided in this memorandum only after consultation with its own advisors.

Executive Summary

We believe that the *Community First* court decision represents “substantial authority” under federal tax law for the position that credit life and disability insurance and GAP coverage at credit unions are exempt from UBIT.

This means that a credit union would not be subject to a civil tax penalty if it filed a UBIT tax return (Form 990-T) treating income from credit insurance and GAP as exempt from UBIT. Also, professional tax return preparers can prepare Form 990-T for a credit union treating credit insurance and GAP as exempt from UBIT without risking the separate civil tax penalty that can be imposed on preparers.

Background

Over the last two years, the Internal Revenue Service released a series of 21 Technical Advice Memoranda (TAMs) dealing with credit union Unrelated Business Income Tax (UBIT) issues. The TAMs take the position that credit life and credit disability insurance, guaranteed asset protection or GAP insurance, and certain other credit union products and activities are “not substantially related” to the tax-exempt purposes of state-chartered credit unions, meaning that the income from those products and activities is subject to UBIT. (Certain other income sources, such as credit/debit card interchange income and income from the sale of checks, have been accepted by the IRS as “substantially related” to credit unions’ exempt purposes, so that income has been ruled exempt from UBIT.)

The IRS position on credit insurance and GAP was challenged in court. In May 2009, a federal court jury in Wisconsin ruled that credit life and disability insurance and GAP coverage made available to members by Community First Credit Union of Appleton, Wisconsin were “substantially related” to Community First’s tax-exempt purposes. The government asked the court to overturn the jury’s verdict, but the court refused to do so. The court granted a tax refund to Community First based on the jury’s verdict, confirming that credit insurance and GAP were not subject to UBIT. The IRS did not appeal the case.

Therefore, the *Community First* case is a final decision of a federal court, specifically rejecting the IRS position on the UBIT treatment of credit insurance and GAP coverage. The court has ruled that credit insurance and GAP sold by a state-chartered credit union are exempt from UBIT.

“Substantial Authority” Analysis

“Substantial authority” has a special meaning under federal tax law. If there is “substantial authority” for a particular position taken on federal tax return, then the taxpayer cannot be subject to the 20% “accuracy-related penalty” imposed by the Internal Revenue Code. See Internal Revenue Code Sec. 6662. The accuracy-related civil penalty increases the tax liability by 20% for (a) any item or position on a tax return that reflects negligence or disregard of rules or regulations, and also (b) any item or position on a tax return that causes an understatement of the correct tax liability by more than 10%. But the penalty does not apply if there is “substantial authority” for the item or position.¹

Also, a professional tax return preparer can be subject to a separate civil penalty for any “unreasonable” position in a tax return that the preparer knows about, but no penalty applies if there is “substantial authority” for the tax return position. See Internal Revenue Code Sec. 6694.

“Substantial authority” for a particular tax return position – such as the position that credit insurance or GAP need not be reported as unrelated business income on Form 990-T – means that the weight of the legal authorities supporting the position is “substantial” in comparison to the authorities on the other side.

The directly applicable authorities for the IRS position on credit life and disability insurance at credit unions consist of the 21 recent publicly released TAMs (all of which deal with credit insurance among other products), plus a single TAM to the same effect publicly released in 1995. All of these TAMs reflect the same basic legal analysis. The directly applicable

¹ IRS regulations confirm that “substantial authority” is a defense to both the negligence/disregard of rules prong and the substantial understatement prong of the accuracy-related penalty. Treas. Reg. §§ 1.6662-3(b)(3), 1.6662-4(d). Those are the most common civil tax penalties. It is also important to note that “substantial authority” also protects against the more serious (and less common) civil fraud penalty that the IRS might assert, since if there was no negligence by the taxpayer because “substantial authority” exists, there was necessarily no fraud.

authority for the IRS position on GAP coverage consists of one of the recent publicly released TAMs (only one of the TAMs discusses GAP).

The directly applicable authorities in support of the credit union position on credit insurance consist of IRS rulings from the early 1970s issued to state-chartered credit unions in three states holding that credit insurance was “substantially related” to credit union exempt purposes – and, most importantly, the recent *Community First* court decision in which the jury ruled, and the judge upheld, that credit insurance was substantially related to Community First Credit Union’s tax-exempt purposes. The directly applicable authority in support of the credit union position on GAP consists of the recent *Community First* court decision in which the jury ruled, and the judge upheld, that GAP coverage was substantially related to Community First Credit Union’s tax-exempt purposes.²

IRS regulations state that in determining whether “substantial authority” exists for a particular position, the relevant authorities must be analyzed with care and their relative persuasiveness considered. It is not a matter of “counting up” authorities on one side or the other.

In the current situation, the *Community First* jury verdict and court decision were the result of a vigorously contested four-day trial in which the purposes and functions of a reasonably typical state-chartered credit union were explained in lengthy testimony. The characteristics of credit insurance and GAP coverage were also the subject of substantial fact testimony as well as expert testimony at the trial. On the basis of this detailed evidentiary record, the jury deliberated and issued a written verdict explicitly stating that credit life insurance, credit disability insurance, and GAP coverage were “substantially related” to Community First Credit Union’s tax-exempt purposes; the court entered an official decision to that effect; and the government did not appeal the decision.

Because of the careful evidentiary record underlying the *Community First* court decision, the weight of the *Community First* decision on credit insurance and GAP is certainly “substantial” in relation to the weight of the TAMs that support the IRS position. The fact that there happen to be 22 publicly released TAMs stating that credit insurance is not “substantially related” to credit union purposes is of little significance; those individual TAMs do not reflect 22 independent analyses, but rather essentially the same analysis repeated 22 times, in many cases using the very same words.³ Thus, in the end, for both the credit insurance issue and the GAP issue, there is an IRS National Office analysis on one side (repeated numerous times in the case of credit insurance), and the *Community First* decision on the other side. IRS regulations on

² There are many court decisions and other authorities in the UBIT area that the IRS and credit unions have cited in support of their respective positions on credit insurance and GAP. Although we believe these authorities support the credit union position, they do not specifically address whether credit unions should pay tax on credit insurance and GAP. So we have not treated these more general authorities as supporting either side for purposes of this “substantial authority” analysis.

³ In fact, Technical Advice Memoranda, like other unpublished IRS rulings, usually do not qualify as a legal precedent at all except for the specific taxpayer involved. TAMs are taken into account in the “substantial authority” analysis, but they are still a weaker kind of authority than a court case.

“substantial authority” are clear that the authority for a particular position need not outweigh the authority on the other side; it must simply be “substantial.” *Community First* is certainly “substantial authority” for a tax return position that reasonably typical credit life and disability insurance and GAP coverage, made available by a reasonably typical state-chartered credit union, are not unrelated trade or business activities that give rise to UBIT liability.⁴

At this time, despite the *Community First* decision, we assume the IRS will still assert that credit insurance and GAP are unrelated business activities at credit unions. Therefore, the IRS may well claim that additional tax is due if a credit union does not report credit insurance and GAP income as unrelated business taxable income on Form 990-T. Credit unions would also be charged interest on any back taxes, since the IRS collects interest automatically (there is no defense against paying interest on back taxes). However, because *Community First* is “substantial authority” for credit unions to treat credit insurance and GAP as non-taxable activities, we believe a credit union will be exempt from civil penalties if it takes that position, and tax return preparers also will be exempt from civil penalties if they prepare Form 990-T on that basis.

⁴ The *Community First* decision covered only credit insurance and GAP, and represents substantial authority only for those products. Additional credit union products addressed by the IRS in the TAMs are the subject of another pending test case that has not been decided yet.