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What is "Fair" Taxation of Credit Unions?

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Effective competition is enhanced by a level playing field. And efficiency of the financial system requires that the tax system should not distort the flow of funds or pricing decisions between different financial institutions (except perhaps where social motives intervene as in the case of superannuation).

Whether the Australian tax system penalizes some types of financial institutions operating in the banking sector and thus impedes their ability to provide better competition with banks is a complex question of current interest. Specifically, mutual financial institutions such as credit unions and some building societies appear to be disadvantaged because they are subject to corporate tax but, unlike banks, are unable (because they are mutuals) to pass the resulting franking credits onto shareholders.

This suggestion of adverse tax treatment warrants much deeper analysis, but the argument appears to have some validity – particularly if credit union members are primarily from lower income groups whose personal marginal tax rate is less than the corporate tax rate of (currently) thirty per cent.

The issue arises because owners of mutual financial institutions are the customers, each of whom has a non-transferable, redeemable, share of nominal value (e.g. $1) on which dividends cannot be paid. Consequently earnings (profit, or surplus - as it used to be called before the accountants insisted on changing the nomenclature) of the credit union are retained in the institution, accumulating to form its capital base which protects deposits of current and future members from loss.

The member-owner-shareholders thus do not receive dividends or capital gains on the capital base which is their ownership stake. That stake is, in effect, ceded to future members when they leave the credit union.

Until the early 1990's Australian credit unions were not subject to company tax. Although no formal inquiry into the financial system nor into the tax system had recommended it, taxation of credit unions was introduced (with initially some concessions for small credit unions). Why that change was thought to be desirable is unclear, although a widespread lack of understanding of its implications for mutuals in a dividend imputation tax system no doubt helped the cause of those pushing it in the cause of equitable tax treatment. Credit unions had not helped themselves either with expansion of common bonds (ie relaxing membership criteria) making them look much more like banks and causing the differential tax treatment to look anomalous.

And such tax treatment of financial mutuals is in distinct contrast to that found in many overseas countries. In the USA, for example, credit unions are not subject to company tax – and because that country operates a classical tax system, this actually provides credit unions with a tax advantage over banks.

If nothing else, the introduction of taxation has slowed the growth of credit unions. Under the Basel Capital Accord and APRA's Prudential Standards, they are required to maintain a minimum level of capital of eight per cent of risk-weighed assets. Consequently, to grow they must increase their capital base – and, with some small exceptions, their mutual status means that this can only be done through retention of earnings. Taxation of earnings reduces the amount which remains to add to the capital base and underpin growth.

But more important are the questions of whether the tax treatment is fair and conducive to efficient financial investment. Answering both of these questions is complicated because the owner's equity in credit unions was not contributed in any pro-rata sense by the current owner-members, but from retained earnings from dealings with past members. So, fairness to current owners (who can easily leave) is not necessarily a relevant criterion.

Similarly, because the capital base (equity) is "inherited", there is not the same imperative to generate a market rate of return on it, as there is for the banks with publicly traded shares. Indeed, credit union managers face a delicate trade-off in that generating higher retained earnings to enable faster future growth comes at the expense of charging current member-borrowers higher interest rates and paying lower interest rates to member-depositors.

For an economist focused solely on the market system and efficiency, the question warranting an answer is whether the tax system distorts the prices which different types of institutions are willing to deal at in the market place. Are there tax-induced differentials between banks and credit unions in the loan and deposit rates they are willing to quote? That, however, neglects the social dimension and, arguably, an externality in the form of the financial and social capital which is generated by the mutual structure with members willing to participate in such institutions and pass on benefits to future generations.

Without detailed analysis and debate about those complexities, a simpler approach is warranted to shed some light on the issue. One way of doing so is to ask the question of whether the total tax paid on the income stream generated by a mutual is the same as that for a hypothetical bank of the same size. The answer is, "it depends", but there are some grounds for believing that the tax burden for mutuals is higher because of the intricacies of the dividend imputation tax system.
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Why might corporate taxation under a dividend imputation system create a competitive disadvantage for mutuals? The essential reason is that dividend imputation means that company tax is essentially "washed out" of the system by dividend payments having franking tax credits attached to them. But mutuals are owned collectively by their members and cannot make dividend payments on their shareholder equity (accumulated over time from retained earnings) and so the company tax paid is not "washed out". Mutuals pay company tax and accumulate franking credits which cannot be distributed. Their situation is akin to requiring that banks could

only pay unfranked dividends to their shareholders, even though the company tax they have paid has generated franking credit balances. Such a requirement would, no doubt, be seen as unfair and inequitable, and could be expected to lead to banks reducing dividends and rewarding shareholders via higher capital gains associated with retention of earnings. While credit unions do (must) retain earnings, current shareholders get no return in the form of capital gain, with the effect of earnings retention being the “social capital” generated.

It may be argued that this situation simply involves a difference in the point of the income stream at which taxation is effectively levied. In the case of a bank, tax is ultimately levied on profits in the hands of the shareholders, with company tax being essentially a pre-payment of personal investor-level tax. In the case of the mutual, tax is levied at the company level, because profits are not distributed. Thus, the overall taxation of bank income is ultimately at a rate equal to the shareholder’s individual tax rate – which given the dominance of superannuation funds as investors perhaps averages in the region of 15 per cent. But for credit unions it is at the company tax rate of 30 per cent.

If credit unions were able, in some way, to distribute franking credits, the situation would change – although it must be remembered that receipt of franking credits is also accompanied by imputed income for tax purposes. Consider, for example, the situation where the mutual had paid $3 of company tax (at rate tc = 0.3) on an income of $10, and had retained, undistributable, income of $7. In principle, if that $7 income could be distributed to members on a personal tax rate of tp, the grossed up taxable income would be $7/(1-tc) = $10 and the member would have a tax bill of $tp.10 but a tax credit of $tc.10 for tax payable of $(tp-tc).10, and total (company and personal) tax paid of $tp.10.

If credit union members have marginal tax rates (tp) less than the company tax rate, they benefit from this outcome (but do not if their personal tax rate is higher). But only the franking credits and imputed income (and not the retained earnings) might be distributed – although what level of imputed income would be involved is problematic. (In the example above, imputed income of $3 was added to the $7 cash dividend received. Whether a mechanism for distributing $3 of franking credits without a cash dividend (payout of retained earnings) would require imputing income of $3 or $10 or some number in between would need to be considered). Distribution of franking credits and imputing income equal to the pre-tax earnings on which company tax was paid (ie $10 taxable income and $3 tax credit in the example) would appear to be beneficial, and equitable vis a vis the banks (with large institutional shareholders on low tax rates) if only those members on low tax rates could elect to receive them (and who would thus receive a tax rebate). Indeed, to force franking credits and imputed income upon high tax rate members (without also distributing the retained earnings) would be unfair because of the tax liability created.

There does thus appear to be some case for considering mechanisms for allowing credit unions to distribute franking credits, and offsetting what appears to be a tax disadvantage vis a vis banks. But the issue is complex, warrants deeper analysis, and would require the design of specific financial instruments which credit unions could issue which would be attractive to low income members. Alternatively, we could return to the previous tax treatment where mutual institutions were not subject to company tax, recognizing their mutual, non-profit, status and potential social benefits from the existence of, and development of, such social capital. But that is also a contentious proposition which requires much deeper analysis.

Disclaimer: Kevin Davis is a Director of Melbourne University Credit Union as well as a shareholder in most Australian banks.

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