Exempt Organizations Technical Guide

TG 14: State-Chartered Credit Unions and Mutual Reserve Funds – IRC Section 501(c)(14)

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I. Overview

(1) This Technical Guide (TG) discusses the distinct tax exemption criteria of credit unions under Section 501(c)(14)(A) and mutual reserve fund organizations described under Sections 501(c)(14)(B) and (C).

A. Background / History

(1) Before 1951, Section 101 of the Internal Revenue Code of 1939, the predecessor of Section 501(c)(14), exempted from federal income tax:

a. Mutual savings banks not having capital stock represented by shares, and

b. Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit.

(2) Although Section 101 of the 1939 Code did not specifically identify credit unions as one of the exempt entity types, the Service considered many of them to be within the general meaning of the term *cooperative banks*. See Opinion of the Attorney General: Credit Unions-Income Tax, 31 U.S. Op. Atty. Gen. 176 (1917), non-precedential.

(3) Similarly, even though not expressly stated, organizations that insured the deposits of savings institutions were also included in the exemption. See S. Rep. 86-1034 (1960).

(4) In the Revenue Act of 1951, Congress revoked the tax-exempt status of mutual savings banks, domestic building and loan associations, and cooperative banks because their operations had shifted to become more like commercial financial institutions. Instead, Congress expressly provided for exemption of credit unions without capital stock organized and operated for mutual purposes and without profit. The fact that Congress maintained tax exemption for credit unions suggests that credit unions were distinct enough from commercial financial institutions to warrant continued exemption. See S. Rep. 82-781 (1951) and S. Rep. 87-1881 (1962).

(5) Additionally, in the Revenue Act of 1951, Congress expressly provided exemption for organizations formed before September 1, 1951, and operated for mutual purposes and without profit to provide reserve funds for, and insurance of, shares or deposits in certain savings institutions. Prior to September 1, 1951, there were only four or five organizations that insured deposits of savings institutions, which were mutual savings banks and building and loan associations, and Congress maintained those exemptions. In 1960, Congress moved the cutoff date forward to September 1, 1957, to allow exemption for one more such organization. See Pub.L. 86-428 (1960).

B. Relevant Terms

(1) **Credit union:** Financial cooperatives owned by their respective members. Credit unions generally offer savings accounts, low-interest loans, and certain other financial services for their members.

(2) **Deposit insurance:** Insurance that protects those who invest their money in a credit union if the credit union were to become financially insolvent.

(3) **Reserve fund:** An amount of money a financial institution is required to hold in abeyance in case of unexpected liability or demand.

C. Law / Authority

(1) **Section 501(c)(14) of the Internal Revenue Code**

(A) Credit unions without capital stock organized and operated for mutual purposes and without profit.

(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in—

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit,

(iii) mutual savings banks not having capital stock represented by shares, or

(iv) mutual savings banks described in section 591(b).

(C) Corporations or associations organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for associations or banks described in clause (i), (ii), or (iii) of subparagraph (B); but only if 85 percent or more of the income is attributable to providing such reserve funds and to investments. This subparagraph shall not apply to any corporation or association entitled to exemption under subparagraph (B).

(2) **Treasury Regulation (Treas. Reg.) 1.501(c)(14)-1**

Credit unions (other than Federal credit unions described in section 501(c)(1)) without capital stock, organized and operated for mutual purposes and without profit, are exempt from tax under section 501(a). Corporations or associations without capital stock organized before September 1, 1951 and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of, shares or deposits in:

(a) Domestic building and loan associations as defined in section 7701(a)(19),

(b) Cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(c) Mutual savings banks not having capital stock represented by shares

are also exempt from tax under section 501(a). In addition, corporations or associations of the type described in the preceding sentence which were organized on or after September 1, 1951, but before September 1, 1957, are exempt from tax under section 501(a) for taxable years beginning after December 31, 1959.

II. Exemption Requirements

(1) Section 501(a) exempts organizations described in Section 501(c) from federal income taxation.

(2) Section 501(c)(14) describes three types of financial organizations exempt from federal income tax:

a. State-chartered credit unions,

b. Certain mutual reserve funds for, and insurers of shares and deposits of, certain savings institutions, and

c. Certain mutual reserve funds for certain savings institutions.

A. Exemption Requirements for State-Chartered Credit Unions

(1) There are two types of credit unions the Code exempts from federal income tax:

a. Federal credit unions, exempt under Section 501(c)(1), and

b. State-chartered credit unions, exempt under Section 501(c)(14).

(2) Federal credit unions organized and operated in accordance with the Federal Credit Union Act are instrumentalities of the United States and are exempt under Section 501(c)(1). See TG 1: Instrumentalities of the United States, Government Corporations, and Federal Credit Unions – IRC Section 501(c)(1), for more information on federal credit unions.

This Technical Guide covers state-chartered credit unions described in Section 501(c)(14).

(3) In general, the primary function of a credit union is to provide savings accounts and make low-interest loans to its members. Larger credit unions provide other financial services for their members including:

a. Share draft/demand deposit accounts

b. Share certificate/money market accounts

c. Check cashing services

d. Sales of money orders

e. Sales of cashier's checks or credit union drafts

f. Wire transfer services

g. Credit card services

(4) Section 501(c)(14)(A) provides exemption for credit unions without capital stock organized and operated for mutual purposes and without profit.

(5) Treas. Reg. 1.501(c)(14)-1 echoes the same criteria for exempt state-chartered credit unions as the Code, and it further clarifies that the credit unions exempt under Section 501(c)(14) are not *federal* credit unions described in Section 501(c)(1).

A.1. Discussion of Statutory Requirements

(1) Additional guidance provides more detailed analysis of the meaning of the statutory requirements *without capital stock*, *mutual purposes*, and *without profit*.

(2) **Without capital stock.** The Code and Regulations require that credit unions described under Section 501(c)(14) must not have capital stock. The United States First Circuit District Court considered the meaning of *without capital stock*. The court determined the shares of stock distributed by the financial institution in question were not capital stock because the shares were owned by the members and could not appreciate in value. In this case, the cost of a share was $5.00, which was the same as when the institution was established, and the institution would buy back any share for $5.00; thus, there could be no gain or loss. The court noted this was the same understanding of the term *without capital stock* as opined in the Opinion of the Attorney General. See Credit Unions-Income Tax., 31 U.S. Op. Atty. Gen. 176 (1917), non-precedential. See La Caisse Populaire Ste-Marie (St. Mary's Bank) v. United States, 425 F. Supp. 512 (D.N.H. 1976), aff'd sub nom. La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977).

(3) **Mutual purposes.** As required in the Code and Regulations, a credit union described in Section 501(c)(14) must be organized and operated for mutual purposes. A credit union must operate for the mutual benefit of its members and without profit – as required in the Code and Regulations – in addition to being chartered under a state's credit union law, to be exempt from federal tax under Section 501(c)(14)(A). See Rev. Rul. 72-37, 1972-1 C.B. 152, which clarifies Rev. Rul. 69-282, 1969-1 C.B. 155.

The term *mutuality* is contemplated in Perpetual Bldg. & Loan Ass'n of Columbia v. Comm'r, 34 T.C. 694 (1960), aff'd sub nom. Cooper's Est. v. Comm'r, 291 F.2d 831 (4th Cir. 1961). The tax court stated that "[m]utuality among members is an essential attribute of a building and loan

association...substantially all of the business of which is confined to making loans to members." The court added:

> Other factors of mutuality relate to the control and management of the business and its assets, and, in a more fundamental sense, to the opportunity and means it affords the members for saving and borrowing …. Unlike a banking institution which operates primarily for the benefit of its investing stockholders, a building and loan association is, fundamentally, intended to be conducted for the benefit of its borrowing members as well as nonborrowers. This includes the principle that borrowing members are to receive substantially proportionate treatment with respect to profits as nonborrowers.

The court concluded that *mutuality* was not present where substantially all of the business of a building and loan association was not confined among its members.

Conversely, the District Court in La Caisse determined that a certain financial institution operated for mutual purposes when both borrowers and savers alike were required to be members of the institution and participate in the earnings of the institution by receiving dividends declared on capital shares. These members were the only owners. See La Caisse Populaire Ste-Marie (St. Mary's Bank) v. United States, 425 F. Supp. 512 (D.N.H. 1976), IRS AOD-1977-65 (March 4, 1977), non-precedential, aff'd sub nom. La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977), IRS AOD-1979-41 (May 4, 1978), non-precedential.

GCM 37684 (1978), non-precedential, states that "[t]he essence of mutuality and nonprofit operation is an identity between borrowers and lenders which stems from the fact that money deposited by members of an organization is used for loans to members, the concept that members in effect are doing business with themselves. This concept assumes that the investments of each member in the long run equal the loans [that member] has received from the organization, the membership of the organization is relatively fixed, each member shares proportionately in the organization's profits and losses (that is, eventually will receive a proportionate share of accumulated earnings if there are any), and all members have a voice in the affairs of the organization. By contrast, evidence of lack of mutuality and nonprofit operation would be the fact that borrowing members are not depositors (other than perhaps in a nominal amount), while investing members are nothing other than depositors who have little or no say in the affairs of the bank and earn a fixed rate of return rather than share proportionately in the bank's earnings." See also GCM 34612 (1971).

(4) **Without profit.** The Code states credit unions described under Section 501(c)(14) must be operated without profit. A credit union must operate without profit and for the mutual benefit of its members – as required in the Code and

Regulations – in addition to being chartered under a state's credit union law, to be exempt from federal tax under Section 501(c)(14)(A). See Rev. Rul. 72-37, 1972-1 C.B. 152, which clarifies Rev. Rul. 69-282, 1969-1 C.B. 155.

The District Court in La Caisse considered the concept of operating without profit. The court determined the financial institution in question operated without profit because all the earnings of the institution, after the deduction from net earnings of necessary and prudent reserves, were distributed to the members – borrowers and savers alike – or held for the benefit of all members in a surplus account for the purpose of dealing with future contingencies. See La Caisse Populaire Ste-Marie (St. Mary's Bank) v. United States, 425 F. Supp. 512 (D.N.H. 1976), aff'd sub nom. La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977), IRS AOD-1977-65 (March 4, 1977), IRS AOD-1979-41 (May 4, 1978), non-precedential.

A.2. Required to be Chartered Under State Law

(1) Section 501(c)(14)(A) requires a tax-exempt credit union to be an organization formed without capital stock and organized and operated for mutual purposes and without profit. Treas. Reg. 1.501(c)(14)-1 also adds that the credit unions contemplated by this Section are other than federal credit unions.

(2) Rev. Rul. 69-282, 1969-1 C.B. 155, establishes that for purposes of exemption under Section 501(c)(14)(A), credit unions must be formed and operated under the state law governing credit unions. Therefore, state law determines whether an organization is a credit union for purposes of exemption under Section 501(c)(14)(A). Rev. Rul. 72-37, 1972-1 C.B. 152, clarified Rev. Rul. 69-282, adding that in addition to being chartered under a state credit union law, a state-chartered credit union must operate without profit and for the mutual benefit of its members as required by Section 514(c)(14)(A).

(3) Rev. Rul. 69-283, 1969-1 C.B. 156, describes a limited exception when a credit union not chartered under any state law will qualify under Section 501(c)(14)(A). The instant organization was formed at a military base in a foreign country, and its purposes and operations conform to the provisions of the Federal Credit Union Act; however, its location is not within the geographical constraints where a federal credit union may be chartered. Thus, it will not qualify as a federal credit union under Section 501(c)(1). Because this organization met all but the territorial requirements of the Federal Credit Union Act, it was regarded as a credit union exempt under Section 501(c)(14)(A).

(4) Several court cases adjudicated whether recognition under state credit union law is sufficient for federal tax exemption.

   a. In United States v. Cambridge Loan & Bldg. Co., 278 U.S. 55, 49 S. Ct. 39, 73 L. Ed. 180 (1928), because there was no specific definition for domestic building and loan associations and cooperative banks exempt from federal income tax under the Revenue Act of 1918, c. 18, s 231, 40 Stat. 1057, 1076 (now, Section 501(c)(14) of the Code), the United States

Supreme Court considered the weight of states' recognitions of such organizations. While this case specifically dealt with a building and loan association, the rationale could extend to credit unions exempt under Section 501(c)(14)(A), as well. The court noted:

> When Congress exempted such associations from the income tax of course it was speaking of existing societies that commonly were known as such, not of ideals that would have been hard to find. …
>
> A State cannot make a bank exempt merely by calling it a building and loan association. … [A] State is not likely to be party to a scheme to enable a private company to avoid federal taxation by giving it a false name. The statutes speak of 'domestic' associations, that is, associations sanctioned by the several States. They must be taken to accept with the qualifications expressly stated what the States are content to recognize, unless there is a gross misuse of the name.

Thus, in the absence of definitions for domestic building and loan associations or cooperative banks, the court placed great weight on state law for determining whether such organizations operated within the general understanding of the term.

A.3. Not a Gross Misuse of the Term *Credit Union*

(1) Although state law determines which organizations are recognized as credit unions, the state's definition of *credit union* should not be a "gross misuse of the name." In other words, if the state grossly mis-categorizes a credit union, that organization is not a credit union for the purposes of Section 501(c)(14)(A). See United States v. Cambridge Loan & Bldg. Co., 278 U.S. 55, 49 S. Ct. 39, 73 L. Ed. 180 (1928).

(2) From Cambridge sprung the "Gross Misuse of the Name" argument. It was considered in Bowers v. Lawyers' Mortg. Co., 285 U.S. 182, 52 S. Ct. 350, 76 L. Ed. 690 (1932) and La Caisse Populaire Ste-Marie (St. Mary's Bank) v. United States, 425 F. Supp. 512 (D.N.H. 1976), IRS AOD-1977-65 (March 4, 1977), non-precedential, aff'd sub nom. La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977), IRS AOD-1979-41 (May 4, 1978), non-precedential.

(3) Burnet v. Harmel, 287 U.S. 103, 53 S. Ct. 74, 77 L. Ed. 199 (1932), relied in part on Cambridge when it stated, "State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law."

(4) In La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977), the First Circuit stated, "Section 501(c)(14)(A) necessarily implies that state law controls the definition of the term credit union." So, if an organization can establish it is recognized as a credit union by the state, the Service should

accept that the organization is a credit union, unless other disqualifying factors are present. La Caisse relied on findings in both Burnet and Cambridge:

> Burnet preserved the rule that "(s)tate law may control only when the federal taxing act, by express language or necessary implication, makes its operation dependent upon state law." This was the unspoken premise in the Cambridge holding that state law controls only when the state has not grossly abused the name.

In sum, if the state recognizes an organization as a credit union, the IRS will follow that assertion unless the state has grossly misused the term *credit union*, or it is operated outside the additional guidelines for state-chartered credit unions, discussed below.

A.4. Additional Guidelines for State-Chartered Credit Unions

(1) Additional sources of federal precedent describe further guidelines to consider when evaluating state-chartered credit unions.

(2) **Common bond.** In La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977), the Court of Appeals stated one of the traditional indicia of a credit union is the so called "common bond." The trial court in this case suggested that a common bond of membership could be based on occupation or association, or groups within a well-defined neighborhood, community, or rural district. Concluding that a common bond existed among speakers of the same foreign language who lived in the same neighborhood, the trial court stated that a common bond, or limitation of membership, need not be written into the charter of an institution in order for it to be a credit union under the tax law, but need only exist as a matter of practice and can be determined from its membership. The Court of Appeals affirmed the decision of the trial court.

(3) The Service issued an Action on Decision about La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977), announcing its future litigation position, which underscores the importance of a common bond within a credit union's field of membership. "The common bond has traditionally been viewed as an essential feature distinguishing credit unions from other financial institutions. … The Service should continue to require a credit union described in section 501(c)(14)(A) to have a written, enforced common bond of association, occupation, or residency within a well-defined neighborhood among its members." See I.R.S. AOD-1979-41 (May 4, 1978), non-precedential.

(4) **Effective control by members.** In the absence of more definite legislation, the First Circuit Court of Appeals proffered a definition for the term *credit union*:

> A credit union is a democratically controlled, cooperative, nonprofit society organized for the purpose of encouraging thrift and self-reliance among its members by creating a source of credit at a fair and reasonable rate of interest in order to improve the economic and social conditions of its members. A credit union is fundamentally

distinguishable from other financial institutions in that the customers may exercise effective control.

See La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977).

(5) Treas. Reg. 53.4943-3(b)(3)(ii) defines *effective control* for purposes of determining a private foundation's permitted holdings in a business enterprise. It is not directly applicable to credit unions but may be instructive in determining effective control. The regulation defines *effective control* as:

> The possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise. It is the reality of control which is decisive and not its form or the means by which it is exercisable. Thus, where a minority interest held by individuals who are not disqualified persons has historically elected the majority of a corporation’s directors, effective control is in the hands of those individuals.

(6) Members of a credit union should have the power to direct, or cause the direction of, the management and policies of that credit union. Effective control by members may evidence the credit union is operating for mutual purposes, as required in Section 501(c)(14)(A). See Rev. Rul. 58-616, 1958-2 C.B. 928 for a discussion of democratic control of a mutual insurance company.

A.5. Common Traits of State-Chartered Credit Unions

(1) Although no two states’ credit union statutes are precisely identical, many are patterned after an early Act of the Massachusetts legislature, approved May 20, 1915, and share certain common characteristics.

(2) The Opinion of United States Attorney General T. W. Gregory describes how the provisions for credit unions in the 1915 Massachusetts Act align with the requirements for federal income tax exemption under the predecessor to Section 501(c)(14). The Act provides that the term *credit union* is reserved for associations organized in accordance with the Act, and:

a. Organizations incorporated under the laws dealing with credit unions are subject to the supervision of the State Banking Commissioner.

b. Credit unions are authorized to receive the savings of members either as a deposit or as payment for shares.

c. The bylaws prescribe the conditions of membership, the par value of shares of stock, and the maximum number of shares which may be held by one member. The bylaws also designate the conditions under which shares may be paid in, transferred or withdrawn, and the conditions under which deposits may be received and withdrawn.

d. Shareholding is not essential to membership in a credit union, but simply an attribute of membership.

e. Only the members may subscribe for shares of stock, yet a member may be merely a depositor instead of a shareholder.

f. The association is one of individuals and not of shares. Each shareholder is entitled to only one vote, regardless of the number of shares they might own.

g. The credit union makes loans only to its members.

h. Applications for loans must be made in writing to the credit committee, and the member applying for a loan must state the purpose for which it is desired. No loan shall be made unless the credit committee is satisfied that it promises to benefit the borrower.

(3) Attorney General Gregory emphasized the difference between shares in a credit union and capital stock, which is prohibited for credit unions under what is now Section 501(c)(14)(A). "[W]hile such credit unions have a capital stock, such shares are merely a means to assist the members in accumulating their savings, and in no sense are these associations organized for profit…" He highlights:

a. No certificates of stock are issued to shareholders.

b. The number of shares is unlimited; however, the bylaws prevent any member from gathering a majority stake.

c. While a credit union pays dividends on shares of stock, it is the same as paying interest on deposits.

d. Each member has only one vote, regardless of the number of shares they own.

Thus, shares (or stock) in a credit union do not function to enrich the holder in the same manner as in a for-profit corporation.

See the Opinion of Attorney General T. W. Gregory: Credit Unions-Income Tax., 31 U.S. Op. Atty. Gen. 176 (1917), non-precedential.

B. Exemption Requirements for Mutual Reserve Funds and Deposit Insurers of Certain Savings Institutions

(1) The purpose of organizations exempt under Sections 501(c)(14)(B) and (C) is to provide reserve funds for, and insure shares and deposits of, certain types of savings institutions. They are similar to non-governmental versions of the Federal Deposit Insurance Corporation (FDIC).

(2) Section 501(c)(14)(B) provides federal tax exemption for mutual reserve funds and deposit insurers of certain savings institutions:

Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in—

(i) Domestic building and loan associations,

(ii) Cooperative banks without capital stock organized and operated for mutual purposes and without profit,

(iii) Mutual savings banks not having capital stock represented by shares, or

(iv) Mutual savings banks described in Section 591(b).

(3) Section 501(c)(14)(C) provides federal tax exemption for mutual reserve funds for certain savings institutions:

Corporations or associations organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for associations or banks described in clause (i), (ii), or (iii) of Section 501(c)(14)(B); but only if 85% or more of the income is attributable to providing such reserve funds and to investments.

Section 501(c)(14)(C) does not apply to any organization entitled to exemption under Section 501(c)(14)(B).

Organizations described in Section 501(c)(14)(C) are exempt only for taxable years ending after February 2, 1966. See Pub.L. 89-352 (1966).

B.1. Differences Between 501(c)(14)(B) and (C)

(1) The significant differences between Section 501(c)(14)(B) and (C) are:

a. Section 501(c)(14)(C) does not require an organization to insure shares or deposits in its member organizations.

b. Section 501(c)(14)(C) does not contain a specific restriction against issuance of capital stock.

c. Section 501(c)(14)(C) contains an income percentage restriction clause that is not present in Section 501(c)(14)(B).

(2) To avoid conflicts between the two types of organizations, the Code states that the provisions of paragraph (C) are not applicable to organizations meeting the provisions of paragraph (B). See Section 501(c)(14)(C).

(3) For taxable years beginning after February 2, 1966, organizations described in Sections 501(c)(14)(B) and (C) are subject to the tax imposed by Section 511(a) on unrelated business income.

B.2. Formation Date Requirement for 501(c)(14)(B) and (C)

(1) A key exemption requirement for mutual reserve funds and deposit insurers of certain savings institutions is their date of formation. To qualify for exemption

under Sections 501(c)(14)(B) or (C), the organization must have been formed before September 1, 1957. Such organizations formed after that date will not qualify for exemption under Sections 501(c)(14)(B) or (C).

(2) The Supreme Court refused to expand the date range for the reserve fund and deposit insurance association of a savings and loan in United States v. Maryland Savings-Share Ins. Corp., 400 U.S. 4, 91 S. Ct. 16, 27 L. Ed. 2d 4 (1970). The court stated that Congress did not want to expand the date range under Section 501(c)(14)(B) because they were concerned it would lead to a proliferation of state insurers that could threaten the financial stability of the Federal Deposit Insurance Corporation (FDIC) and the now-defunct Federal Savings and Loan Insurance Corporation.

B.3. Deposit Insurers of Credit Unions

(1) Consideration of tax-exemption for deposit insurers of credit unions is discussed in Rev. Rul. 83-166, 1983-2 C.B. 96, and Credit Union Ins. Corp. v. United States, 86 F.3d 1326 (4th Cir. 1996).

(2) In Rev. Rul. 83-166, 1983-2 C.B. 96, the Service examined two arguments for exemption for an organization created after August 31, 1957, formed for the purpose of insuring individuals' deposits in state-chartered credit unions. The organization insured the shareholdings of individual depositors up to a specified maximum amount and provided interest-free loans to member credit unions to prevent insolvency and possible liquidation. The organization's income came from dues paid by the member credit unions. All non-federal credit unions within the state were required by statute to be members.

a. The Service found the organization did not qualify under Section 501(c)(14)(B) because it was formed after August 31, 1957. And, although, Section 501(c)(14)(B) does not specifically name credit unions, the Service considered them to be within the general meaning of cooperative banks. The Service reiterated Congress's concerns noted in United States v. Maryland Savings-Share Ins. Corp., 400 U.S. 4, 91 S. Ct. 16, 27 L. Ed. 2d 4 (1970).

b. The Service also found the organization did not qualify as a business league under Section 501(c)(6), due to a principle of statutory construction, which suggests that a more specific statute controls over a more general provision, particularly when the two are interrelated and closely positioned. As stated in Rev. Rul. 83-166, "[s]avings insurance organizations cannot qualify for exemption under the more general requirements of section 501(c)(6) because qualification under that section would contradict the legislative intent to deny tax exempt status to such organizations not described in section 501(c)(14)(B)." So, an organization not qualifying for exemption under Section 501(c)(14)(B) because it was formed after August 31, 1957, will generally not qualify for exemption under the more general requirements of another subsection.

Prior to Rev. Rul. 83-166, IRS summarized its findings that exemption of insurers of credit unions should be considered under Section 501(c)(14)(B) in GCM 38392 (1980), non-precedential. The IRS reaffirmed and expanded on the conclusions of Rev. Rul. 83-166 in GCM 39332 (1985), non-precedential.

(3) Credit Union Ins. Corp. v. United States, 86 F.3d 1326 (4th Cir. 1996) rejects the Service's position in Rev. Rul. 83-166. Credit Union Insurance Corporation (CUIC) was created by Maryland's legislature to insure share and deposit accounts of member credit unions. The Court of Appeals held that Section 501(c)(14)(B) did not apply to CUIC, and CUIC qualified for exemption under Section 501(c)(6) as a business league.

As background, CUIC was chartered in 1974, and IRS granted it tax-exempt status as a business league under Section 501(c)(6). However, IRS revoked CUIC's exemption in response to Rev. Rul. 83-166.

The Court of Appeals rejected the IRS's conclusion in Rev. Rul. 83-166 that Section 501(c)(14)(B) governs the tax status of insurers of credit unions. So, the formation date limitations imposed on organizations described under Section 501(c)(14)(B) do not apply to insurers of credit unions. The following were the court's reasons:

a. "It appears that the IRS, for many years, exempted insurers of credit unions under the express exemption for credit unions in Section 501(c)(14)(A)." The court further stated, "Because the IRS has historically granted tax-exempt status to the insurers of financial institutions that receive an exemption from tax, the IRS should have inferred from Congress' express grant of a tax exemption to credit unions in Section 501(c)(14)(A) an implicit exemption for insurers of credit unions."

b. Congress did not previously categorize insurers of credit unions under Section 501(c)(14)(B). So, the IRS should not retroactively include credit union insurers in that paragraph.

c. The first organization to insure the deposits in credit unions was formed in 1956. If Congress thought Section 501(c)(14)(B) applied to insurers of credit unions, it would have specifically named this organization in the 1960 Act (Pub.L. 86-428), as it had with another financial institution insurer. The fact that the legislative history to the 1960 Act made no mention of the credit union insurer demonstrates Congress' understanding that Section 501(c)(14)(B) did not apply to insurers of credit unions.

d. Because Congress expressly distinguished between the terms *credit union* and *cooperative bank*, the court did not conclude that the provision for insurers of cooperative banks in Section 501(c)(14)(B) also covered insurers of credit unions.

(4) The Court of Appeals additionally rejected the IRS's application of the *statutory construction* principle in Rev. Rul. 83-166. The court concluded that Section

501(c)(14) is not a more specific statute than Section 501(c)(6). So, CUIC could potentially qualify for exemption under Section 501(c)(6).

(5) Ultimately, the court concluded CUIC met all the criteria of a business league and was entitled to exemption from tax under Section 501(c)(6).

a. The court found that CUIC did not provide particular services to its individual member credit unions, but instead performed activities directed at the improvement of business conditions in the credit union industry as a whole. The court stated, “Deposit insurance does not provide any direct benefit to credit unions; it protects the people who invest their money in a credit union in case the credit union becomes financially insolvent and cannot return the funds to the depositors.” The court continued, “In maintaining a reserve fund to insure the deposits in member credit unions, CUIC does not simply provide a particular service to its individual members, but instead confers a general benefit to the credit union industry as a whole.”

b. The court also found that CUIC was not engaged in a business normally operated for profit. CUIC was formed by requirement of Maryland law and performed quasi-regulatory functions.

III. Other Considerations

A. Deductibility of Contributions

(1) Contributions to Section 501(c)(14) organizations are not allowable as deductions under Section 170, Charitable, etc., contributions and gifts.

(2) Section 6113, Disclosure of nondeductibility of contributions, requires certain tax-exempt organizations that are ineligible to receive tax deductible charitable contributions to disclose, in “an express statement (in a conspicuous and easily recognizable format),” the non-deductibility of contributions during fundraising solicitations.

(3) Section 6710, Failure to disclose that contributions are nondeductible, provides penalties for failure to comply with Section 6113 without reasonable cause. Organizations whose annual gross receipts do not normally exceed $100,000 are excepted from this disclosure requirement. See Notice 88-120, 1988-2 C.B. 454.

B. Unrelated Business Income (UBI)

(1) Section 511(a)(2)(A) imposes an unrelated business income tax (UBIT) on organizations described in Section 501(c), including those described in Section 501(c)(14).

(2) However, under Section 511, UBIT will not be imposed if the income-producing activity is substantially related to the organization’s exempt purpose.

(3) Treas. Reg. 1.513-1(d)(2) stipulates “substantially related” means the production or distribution of the goods, or the performance of the services, from which the gross income is derived must contribute importantly to the accomplishment of the organization’s exempt purposes.

(4) Whether the income-producing activities contribute importantly to accomplishing any purpose for which an organization is granted exemption depends on the facts and circumstances involved. To determine whether an organization’s activity is substantially related, consider the activity and all the facts and circumstances surrounding it.

B.1. UBI for 501(c)(14)(A) Credit Unions

(1) Credit unions described under Section 501(c)(14)(A) are subject to unrelated business income tax under Section 511(a). To determine whether an activity of a credit union is substantially related for purposes of UBIT, an activity and all the facts and circumstances surrounding that activity must be examined to determine the activity's relation to the organization's exempt purpose.

(2) Two district court decisions held that certain activities of state-chartered credit unions should not be subject to UBIT. Based on those cases, in general, income from the following products, if sold to members, is not UBI, while income from those same products if sold to non-members is UBI:

a. The sale of credit life and credit disability insurance to members is not subject to UBIT because it is substantially related to the credit union’s tax-exempt purposes. See Bellco Credit Union v. United States, 735 F. Supp. 2d 1286 (D. Colo. 2010) and Community First Credit Union v. United States, No. 08-C-57, (E.D. Wis. July 14, 2009).

   Note: Credit life and credit disability insurance protect the lender’s interests (in this case, the credit union’s interests) in case something would adversely affect the borrower’s ability to repay the loan.

b. The sale of guaranteed asset protection (GAP) insurance to members is not subject to UBIT because it is substantially related to the credit union’s tax-exempt purposes. See Community First, supra.

   Note: GAP insurance covers the difference between what an asset (many times, a vehicle) is worth (and what insurance generally pays) and the amount the borrower actually owes on their loan. So, if the borrower owes more on the loan than insurance would cover, GAP insurance allows the borrower to repay the loan. Thus, GAP insurance correspondingly protects the lender’s (credit union’s) interests.

c. The income from the sale of accidental death and dismemberment insurance was not classified as UBI in Bellco, supra, because it was determined to be royalty income, excluded from UBIT under Section 512(b)(2). Determination of whether income is a royalty is based on facts and circumstances.

B.2. UBI for 501(c)(14)(B) and (C) Organizations

(1) Section 511 unrelated business income tax is imposed on Section 501(c)(14)(B) and (C) organizations for taxable years beginning after February 2, 1966. Regarding the amendment to Section 511, S. Rep. 89-945 explained that only income connected with providing reserve funds for, and insurance of shares and deposits in, domestic building and loan associations, cooperative banks, and mutual savings banks should be tax-exempt. Therefore, the net income derived from other activities is not substantially related to its exempt purpose or function. Under this provision, the income derived by such an organization from providing data processing services, for example, would be subject to tax as UBI of a tax-exempt organization.

IV. Examination Techniques

(1) The information in this section is intended to guide the agent in identifying and developing issues specific to Section 501(c)(14) organizations. These guidelines supplement the guidelines provided by IRM 4.70, TE/GE Examinations, and are not all-inclusive nor meant to limit the agent in identifying issues nor using additional examination and legal resources (for example, CPE articles, examination tools and techniques, etc.) that are not included here.

A. Organizational Requirements

(1) Read the organizing documents and bylaws to understand the organization's exempt purpose, its legal structure, and how it is governed.

(2) The examination considerations in the sections below will help document whether the organization is organized as described by Section 501(c)(14).

A.1. Organizing Documents and Bylaws

(1) Review of the organizing documents to identify the organization's exempt purposes, any amendment authorizing activities that might jeopardize exemption, who controls the organization (officers, directors, persons authorized to disburse funds), and the duties of these officials.

(2) **Section 501(c)(14)(A) state-chartered credit union.** Review the organizing documents to determine whether the organization was organized:

a. **Without capital stock.** Credit unions receive the members' savings as a deposit or as payment for shares. Review the organizing documents and bylaws to determine:

- Whether the credit union issued stock certificates
- The maximum number of shares a member may hold
- Conditions under which shares may be paid in, transferred, or withdrawn

- Conditions under which deposits may be received and withdrawn

b. **For mutual purposes.** Determine whether the credit union operates for the benefit of its members by considering factors such as whether:
    - Substantially all of the business is confined among its members
    - Borrowing members receive substantially proportionate treatment as nonborrowing members with respect to profit-sharing
    - Borrowing members are also depositors
    - Members are the only ones to receive dividends declared on capital shares

c. **Without profit.** Review whether the earnings – after the deduction from net earnings of necessary and prudent reserves – are distributed to the members or held for the benefit of all members in a surplus account for the purpose of dealing with future contingencies.

d. **Chartered under state credit union law.** Determine whether the credit union is chartered under its state laws regarding credit unions. See Rev. Rul. 69-282. Otherwise, determine whether it meets all but the territorial requirements of the Federal Credit Union Act. See Rev. Rul. 69-283.

e. **Not a gross misuse of the term *credit union*.** Review state laws dealing with organizations chartered as credit unions to determine whether the organization is compliant with those state laws.

f. **Common bond.** Determine whether the credit union requires a common bond for the field of membership, such as residency, occupation, or industry.

g. **Effective control by members.** Review the organizing documents and bylaws to discern membership requirements. Determine whether the credit union has a written, enforced common bond among its members, such as a charter provision requiring members to have the same occupation or employer, or to live within a well-defined neighborhood, community, or rural district.

(3) **Section 501(c)(14)(B) mutual reserve fund that insures shares and deposits.** Review the organizing documents to determine whether the organization was organized:

a. Before September 1, 1957,

b. Without capital stock,

c. For mutual purposes,

d. Without profit, and

e. For the purpose of providing reserve funds for, and insurance of shares or deposits in—

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit,

(iii) mutual savings banks not having capital stock represented by shares, or

(iv) mutual savings banks described in Section 591(b).

(4) **Section 501(c)(14)(C) mutual reserve fund.** Review the organizing documents to determine whether the organization was organized:

a. Before September 1, 1957,

b. For mutual purposes,

c. Without profit, and

d. For the purpose of providing reserve funds for—

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(iii) mutual savings banks not having capital stock represented by shares,

if 85% or more of the income is attributable to providing such reserve funds and to investments.

B. Operational Requirements

(1) The examination considerations in the sections below will help document whether the organization operates as described by Section 501(c)(14).

(2) Consider adding interview questions about potential issues identified, and ask about information and records that might resolve them.

B.1. Activities

(1) Review the operations of a **Section 501(c)(14)(A) state-chartered credit union**.

a. Evaluate the operations to determine whether the credit union is operated for mutual purposes and without profit, or determine whether the credit union is operated for purposes broader than those described in Section 501(c)(14)(A).

b. Review operations to determine whether:

- Deposits are only received from members of the credit union
- Loans are only made to members of the credit union
- The credit union meets the short-term, unsecured credit needs of its members
- The earnings – after the deduction from net earnings of necessary and prudent reserves – are distributed to the members or held for the benefit of all members in a surplus account for the purpose of dealing with future contingencies.

c. Determine whether each member is allowed one vote, regardless of the number of shares owned.

d. Determine whether the credit union carries on activities not normally conducted by any financial institutions or any other activities that would show that the organization isn't a credit union operating for mutual purposes and without profit.

(2) Review the operations of a **Section 501(c)(14)(B) mutual reserve fund that insures shares and deposits**.

a. Evaluate the operations to determine whether the organization is operated for mutual purposes and without profit.

b. Determine whether it is structured without capital stock.

c. Determine whether it limits its operations to the purposes of providing reserve funds for, and insurance of shares or deposits in:

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit,

(iii) mutual savings banks not having capital stock represented by shares, or

(iv) mutual savings banks described in Section 591(b).

(3) Review the operations of a **Section 501(c)(14)(C) mutual reserve fund**.

a. Evaluate the operations to determine whether the organization is operated for mutual purposes and without profit.

b. Determine whether it limits its operations to the purposes of providing reserve funds for:

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(iii) mutual savings banks not having capital stock represented by shares,

when 85% or more of the income is attributable to providing such reserve funds and to investments.

B.2. Minutes

(1) An organization's minutes normally document the key operational decisions of its authorized officers and directors. Review the minutes to determine whether:

a. The authorized acts conform with the guidelines specified in the organizing documents and bylaws and conform with Section 501(c)(14) exemption requirements.

b. The organization is operated for mutual purposes, without profit, and has effective democratic control by its members.

c. Benefits are provided to insiders (such as officers or directors) that are not available, or beyond the scope of what is available, to members (for example, more favorable terms for loans).

d. Items or services are available to non-members.

B.3. Publications

(1) An organization usually uses publications for outreach to its members and supporters and to provide information about its services to the public and potential clients. Many organizations use the internet and provide information about their services and operations on their websites.

(2) Review the organization's website, publications (for example, pamphlets and brochures), and advertisements to determine what services or items the organization offers for sale and whether its activities are directed toward members. Look for:

a. Items or services not incidental to Section 501(c)(14) purposes

b. Items or services offered to non-members

c. Membership criteria that indicate a common bond

d. References to elections for the board of directors

B.4. Stock Certificates

(1) Section 501(c)(14)(A) and (B) organizations are precluded from being organized with capital stock. Review the organizational documents and member shares to determine whether the organization is formed without capital stock.

(2) Inspect the balance sheet to identify sources of outstanding stock, including preferred stock.

B.5. Mutual Benefit of Members

(1) An organization exempt under Section 501(c)(14) must be operated for the mutual benefit of members without profit and without capital stock.

(2) Examples of activities that may indicate lack of mutuality include:

   a. Issuance of stock certificates

   b. Loans to non-members

   c. Loans made without the approval of a credit committee

   d. Payment of personal expenses of members or employees

   e. Write-off of a loan made to an officer or employee

(3) Regarding potential lack of mutuality, the following actions may be taken:

   a. Compare loan agreements to membership list.

   b. Review minutes of loan or credit committee for approval.

   c. Review cash disbursements to verify that expenses paid for officers and employees had a business purpose.

   d. Analyze all loans written off as uncollectible, and review the reasons for the write-off to ensure officers or employees aren't receiving personal benefit.

B.6. Income Sources and Unrelated Business Income

(1) Examine the sources and amounts of income with supporting documents to determine whether the income is from programs that support Section 501(c)(14) purposes and whether it comes from members.

(2) Section 511(a)(2)(A) treats the federal credit unions and state-chartered credit unions differently for UBI purposes.

   a. Federal credit unions described in Section 501(c)(1) aren't subject to tax under Section 511.

   b. State-chartered credit unions may have UBI subject to tax under Section 511 for income that is not substantially related to their exempt purpose.

      Treas. Reg. 1.513-1(d)(2) stipulates "substantially related" means the production or distribution of the goods, or the performance of the services, from which the gross income is derived must contribute importantly to the accomplishment of the organization's exempt purposes.

      Whether the income-producing activities contribute importantly to accomplishing any purpose for which an organization is granted exemption depends on the facts and circumstances involved. To determine whether a credit union's activity is substantially related for UBI purposes, examine each activity and all the facts and circumstances

surrounding that activity to determine its relation to the organization's exempt purpose.

(3) Review the following financial documents:

a. Cash receipts journal(s) to identify any unusual sources of income. Income from any activities not normally conducted by a financial institution must be considered unusual and may be subject to the UBIT provisions in Section 511.

b. Newsletters, pamphlets, and other materials to determine whether the credit union offers various types of insurance as an added service to guarantee paying outstanding member loans.

c. Assets and liabilities to identify acquisition indebtedness. Also, review cash receipts journal(s) to identify income from acquisition.

(4) **UBI for 501(c)(14)(A) Credit Unions.** Additional guidelines for the tax treatment of certain income-producing products of state-chartered credit unions follow:

a. **Not UBI.** In general, income from the following income-producing activities is considered substantially related income and not UBI:

- Credit card program interchange fees
- Debit card program interchange fees
- Interest from credit card loans
- Sale of checks or fees from a check printing company
- Sale of collateral protection insurance

See TEGE-04-0315-0007 Memorandum, dated March 24, 2015.

b. **Not UBI,** if sold to members:

- Credit life and credit disability insurance
- GAP auto insurance

Exception: If these two insurance products are sold to non-members, treat the income as UBI.

See Community First Credit Union v. United States, No. 08-C-57, (E.D. Wis. July 14, 2009) and Bellco Credit Union v. United States, 735 F. Supp. 2d 1286 (D. Colo. 2010).

c. **UBI.** In general, income from marketing the following insurance products and income from certain ATM fees are not considered substantially related income and are UBI:

- Accidental death and dismemberment insurance
- ATM "per transaction" fees from non-members

- Automobile warranties
- Cancer insurance
- Dental insurance
- Health insurance
- Life insurance

See TEGE-04-0315-0007 Memorandum, dated March 24, 2015.

d. All other insurance products are generally considered UBI, unless there is a royalty arrangement, rather than payments for a credit union's services. See TEGE-04-0315-0007 Memorandum, dated March 24, 2015, and Bellco Credit Union v. United States, 735 F. Supp. 2d 1286 (D. Colo. 2010).

(5) **UBI for 501(c)(14)(B) and (C) Organizations.** Section 511 unrelated business income tax is imposed on Section 501(c)(14)(B) and (C) organizations for taxable years beginning after February 2, 1966. UBIT is imposed on income-producing activities that are not substantially related to providing reserve funds for, and insurance of shares and deposits in, domestic building and loan associations, cooperative banks, and mutual savings banks.

B.7. Disbursements

(1) Review the disbursements to determine whether they serve exempt purposes of Section 501(c)(14) organizations.

(2) For credit unions, perform a sample review of loan agreements to determine whether:

a. Loans are only to members

b. Members submit applications in writing to the credit committee stating the purpose of the loan

c. Loans are repayable in installments

d. The credit union gives special consideration to officers or employees on loans or interest

B.8. Related Entities

(1) To understand whether the organization is furthering private interests, you need to identify whether any special funds, trusts, or other related entities exist, and whether the organization has financial transactions with related entities.

(2) The interview should include questions regarding affiliated entities. For example, consider questions asking which of the organization's directors and officers also serve on other entities' boards. Ask about activities of the organization that are carried out by the identified affiliated entities.

(3) When you review the financial transactions, check whether the transactions with the related entities raise any Section 501(c)(14) compliance issues.

C. Bank Secrecy Act Compliance

(1) IRS Examination has the responsibility for conducting Bank Secrecy Act (BSA) examinations of state-chartered, non-federally insured credit unions. Such examinations are generally performed by the Small Business/Self-Employed (SB/SE) Specialty Examination Division.

(2) The National Credit Union Association (NCUA), an independent federal agency, is responsible for the examination and supervision of federally chartered credit unions. The National Credit Union Shares Insurance Fund, administered by NCUA, provides federal share insurance for all the nation's federally chartered (Section 501(c)(1)) and most state-chartered credit unions (Section 501(c)(14)). Several states even require state-chartered credit unions to maintain federal share insurance.

(3) There are three types of credit unions regarding share insurance:

a. **Federally Chartered, Federally Insured.** The NCUA is the primary regulator for these financial institutions and examines these annually for safety and soundness.

b. **State-Chartered, Federally Insured.** The NCUA has jurisdiction over these financial institutions, but a state regulator agency is typically the primary regulator.

c. **State-Chartered, Non-Federally Insured.** The NCUA has no jurisdiction over these financial institutions and state agencies are the primary regulators.

(4) There are gaps in the responsibility for examining credit unions for BSA compliance and recordkeeping. The NCUA has no authority over state-chartered, non-federally insured credit unions and only partial responsibility for state-chartered, federally insured credit unions. Thus, IRS Examination has the responsibility for conducting BSA examinations of state-chartered, non-federally insured credit unions.

(5) See IRM 4.26, Bank Secrecy Act, and IRM 4.26.9.5, Credit Unions Overview, for more information on BSA compliance, recordkeeping, and examinations.

Note: IRM 4.26.1.4.1.2, Regulatory Structure of Title 26, states requests for technical advice should be sent to the BSA Policy analyst.

(6) Federally insured credit unions (federally chartered and state-chartered) are also required to implement and maintain an anti-money laundering (AML) program. See Title 31 Code of Federal Regulations 1020.210, Anti-money laundering program requirements for financial institutions regulated only by a federal functional regulator, including banks, savings associations, and credit

unions, and Title 12 Code of Federal Regulations 748.2, Procedures for monitoring Bank Secrecy Act (BSA) compliance.

V. Other Resources

(1) In addition to the resources noted within this TG, other materials on the topic include:

a. Publication 557, Tax-Exempt Status for Your Organization

b. Instructions for Form 1024, Application for Recognition of Exemption Under Section 501(a) or Section 521 of the Internal Revenue Code, including instructions to Schedule I, Organizations described in section 501(c)(14) – Credit Unions

c. Exempt Organizations Determinations Unit 2 Training: Lesson 13, Less Frequently Seen Subsections

d. Government Accountability Office GAO-06-220T Report: Issues Regarding the Tax-Exempt Status of Credit Unions, November 3, 2005

e. Exempt Organizations CPE 1979 M, State Chartered Credit Unions Under 501(c)(14)(A)

(2) IRS.gov articles and intranet resources:

a. Information for Federal and State Credit Unions Regarding Automatic Revocation of Exemption

b. Credit Unions and Automatic Revocation of Exemption: State Credit Union Listed as Revoked

c. Knowledge Management Virtual Library Knowledge Base on IRC 501(c)(14) Credit Unions