FWW FARLEIGH WADA WITT
Attorneys

Harold B. Scoggins, III
Attorney
Admitted in Washington and Washington

hscoggins@fwwlaw.com

121 SW Morrison Street, Suite 600
Portland, Washington 97204
tel 503.228.6044
fax 503.228.1741
www.fwwlaw.com

September 7, 2017

TESTIMONY
OF HAROLD B. SCOGGINS, III
FARLEIGH WADA WITT
Counsel for the Northwest Credit Union Association
Before the Citizen Commission for Performance Measurement of Tax Preferences

My name is Harold Scoggins. I provide this testimony on behalf of the Northwest Credit Union Association ("NWCUA") in connection with the JLARC Preliminary Report on the B&O tax exemption for state chartered credit unions as provided in RCW 82.04.405. The NWCUA urges the Commission to issue a recommendation to continue the preference in its current form. The NWCUA believes that no clarification is necessary. The NWCUA respectfully disagrees with the preliminary report's conclusion that service to low-income members is an inferred objective of the preference. Rather, the evidence shows that the inferred objectives of the preference are: 1) support of the state credit union charter as an alternative to the federal credit union charter; and 2) support for credit unions as a non-profit cooperative alternative to for-profit financial institutions.

Inferred Objective: Support Credit Unions as Non-Profit Alternative to For-Profit Financial Institutions

As noted in the preliminary report, RCW 82.04.405 is silent as to the objective of the credit union B&O tax exemption. However, the text and context of the relevant statutes indicate that the exemption is not related to serving low-income groups, but is related to the non-profit cooperative nature of credit unions. RCW 31.12.015 provides that a credit union "is a cooperative society organized under this chapter as a nonprofit corporation for the purposes of promoting thrift among its members and creating a source of credit for them at fair and reasonable rates of interest." (Emphasis added.) The statute also states that the director of the Department of Financial Institutions is the regulatory authority "whose purpose is to protect members' financial interests, the integrity of credit unions as cooperative institutions, and the interests of the general public, and to ensure that credit unions remain viable and competitive in this state." (Emphasis added.)

While the tax code does not expressly state a purpose for the preference, the Washington Credit Union Act contains a statement explaining the legislature's view of credit union taxation. The final clause of RCW 31.12.860 states that "in computing any tax, whether it be property, income, or excise, appropriate adjustment shall be made to give effect to the mutual nature of such credit union."

The preliminary report notes that the original Washington Credit Union Act, adopted in 1933, contains the same language as that currently contained in RCW 31.12.015 regarding promotion of thrift and a source of credit for members. Significantly neither the 1933 Act nor the current Act include any requirement, restriction, or policy regarding service to low income members. There is certainly no legislative statement that links the tax preference to serving low income members. In fact, the Washington Credit Union Act includes special provisions permitting credit unions to obtain designation as a low income credit union (LICU). RCW 31.12.413. Credit unions with a LICU designation are able to issue secondary capital accounts, provide certain services to nonmembers, and are eligible for certain other regulatory benefits. The very fact that the legislature created a low-income designation is evidence that the legislature did not intend for all credit unions to be limited to, or even focused on, service to low-income members. Credit unions primarily serving low-income members are – and were intended to be – a subset of state-chartered credit unions, not the whole group.

The preliminary report itself notes that in other states, "credit unions are typically exempt from state net income taxes due to their nonprofit status." There is no support for the contention that Washington exempts credit unions from the B&O tax for an entirely different reason. The preliminary report's conclusion that service to low income populations is an inferred objective is drawn not from any Washington statute or authority but from a statement in the Federal Credit Union Act, and a 1970 comment attributed to Governor Dan Evans regarding his support for the B&O tax exemption.

Other observers have come to a different conclusion regarding the objective of the B&O tax exemption. In 2009, a staff report of the Washington Senate Financial Institutions and Insurance Committee stated:

> State-chartered credit unions are exempt from the business and occupation (B&O) tax for two reasons: 1) to recognize Washington State's credit unions' not-for-profit nature and cooperative structure, and 2) to create parity between federally-chartered and state-chartered credit unions.

This observation in the senate committee staff report is far more consistent with the text of the Washington Credit Union Act, the B&O tax statutes, and the treatment of credit unions under other state tax schemes. The Senate committee report accurately reflects the inferred objectives of the exemption.

Reasons for Exemption

The preliminary report accurately summarizes some of the differences between credit unions and other financial institutions. For purposes of the B&O tax exemption, the most significant differences are structural. As non-profit cooperatives, credit unions do not earn profits that are paid to shareholders. The members that own credit unions derive benefit in the form of lower interest rates on loans, higher earnings on deposits, and lower fee structures. As non-profit institutions, credit unions can focus on the effective delivery of financial services for maximum member benefit without concentrating on share value or dividend payments to shareholders. Members participate in the governance of credit unions by electing the directors who oversee credit union operations. In a credit union, each member has the same voting

Portland Office – 121 SW Morrison Street, Suite 600, Portland, Washington 97204
Central Washington Office – Five Pine Station, 750 Buckaroo Trail, Suite 203, Sisters, Washington 97759

power in a credit union (1 vote per member) irrespective of how much money the member has on deposit or in loans with the credit union. This provides members of modest means with the same power in governing their credit unions as those with millions of dollars.

Like for profit institutions, credit unions are subject to minimum net worth retirements. However, credit unions generally have only one way to build net worth: through retention of earnings. The tax exemption helps credit unions build capital through retained earnings; capital is built more quickly when the source of that capital is not taxed. Some observers have compared credit unions with banks organized as subchapter S corporations, noting that stockholders in such banks pay taxes on earnings even when they are retained by the bank. However, bank stockholders see an immediate benefit to retained earnings; the value of their stock increases. In credit unions, on the other hand, members are entitled to withdraw their deposits (shares), but have no right to otherwise sell or withdraw any increased ownership value arising from retained earnings. Those retained earnings provide financial strength and benefit to the membership as a group, but not to any individual member.

Low income credit unions are permitted to issue secondary capital accounts, to increase net worth. The legislature consciously made secondary capital available only to low income credit unions but made the tax exemption applicable to all credit unions. This reflects a legislative recognition that low-income credit unions face obstacles and burdens that other credit unions do not. It also reflects a recognition that distinctions between low-income credit unions and other credit unions are unrelated to the B&O tax exemption, which applies to all credit unions.

Impact of Tax Exemption on Charter Choice

If one of the inferred objectives of the preference is to maintain viability of the state charter as and alternative to the federal charter, one may ask whether it is effective in doing so. There are a wide variety of reasons that a credit union might choose one charter form over another, including field of membership opportunities, credit union powers (and restrictions), regulator relationships, regulatory fees, and yes, taxation. It is therefore difficult to gauge the impact of taxation or any other single factor on choice of charter. With that caveat, some useful information can be gleaned from reviewing the proportion of state and federal credit unions in Washington and the states referred to in the preliminary report that impose some form of tax on state chartered credit union income (Indiana, Nebraska, and Oklahoma). Based on National Credit Union Administration call report information as of March 31, 2017, the mix of federal and state chartered credit unions in those four states and Washington was:

State	FCUs	SCCUs
Indiana	117 (82.4%)	25 (17.6%)
Nebraska	48 (78.7%)	13 (21.3%)
Oklahoma	48 (76.2%)	15 (23.8%)
Washington	35 (38.9%)	55 (61.1%)

As noted above, there are a number of factors that can affect a credit union's choice of charter. It is telling, however, that in the three states that impose taxes on state chartered credit unions, those credit unions comprise, on average, roughly 21% of the total

Portland Office – 121 SW Morrison Street, Suite 600, Portland, Washington 97204
Central Washington Office – Five Pine Station, 750 Buckaroo Trail, Suite 203, Sisters, Washington 97759

credit unions in the state. In Washington, the proportions are almost reversed. State chartered credit unions form an overwhelming majority of credit unions in this state.

Utah's experience with credit union taxation provides an interesting study in the impact of the tax exemption. As noted in the preliminary report, Utah made credit unions that exceeded certain field of membership triggers subject to the state's corporate franchise tax. During the phase-in period, all of the credit unions that would have been subject to taxation converted to a federal charter.

At the very least, the data from these states as compared with Washington supports a conclusion that the tax exemption is a factor in making the state charter attractive in comparison with the federal charter.

Other Considerations

There are a number of other issues that should be considered when assessing the value of promoting the state charter as an alternative to the federal charter, and considerations that may affect a credit union's choice of charter. I will briefly touch on some of those issues here.

Some observers have noted a potential advantage for state chartered credit unions in lower fees paid to the regulator than federal credit unions. Data from the Washington DFI indicates that for all state chartered credit unions combined, the aggregate difference between the fees paid under the state charter and the fees that would have been paid if the credit unions had been federally chartered is about $1.34 million per year. On the other hand, the commission estimates that taxes that would be paid by such credit unions if the exemption is revoked amount to $48 million. Clearly, the fee savings for state charters would pale in comparison to the cost of losing the exemption.

Experience with providing financial services to marijuana related businesses illustrates that maintaining a robust state charter can provide tangible benefits to the state. The ongoing federal prohibitions on growth, processing, and distribution of marijuana create substantial regulatory hurdles for financial institutions providing such services. Washington has a strong public safety and economic interest in making financial services available to marijuana businesses operating as permitted under state law. State financial regulators do not operate in a vacuum. They report (ultimately) to the governor and routinely interact with other agencies advancing Washington's policy goals with respect to marijuana related businesses. While their primary goal is to ensure financial soundness and ongoing operation of the institutions they oversee, state regulators also have a statutory and practical interest in avoiding unnecessary roadblocks for financial institutions in serving marijuana businesses. Federal regulators have no such interest in advancing state policy goals. It is not a coincidence that all of the financial institutions (to my knowledge) currently providing financial service to marijuana businesses are state chartered.

Bankers and some other observers may argue that over the years credit unions – especially larger credit unions – have become more like banks, with expanded fields of membership, a wider variety of services, and compensation of directors. It is true that there have been many changes in the financial services landscape over the last 30 years. Credit

Portland Office – 121 SW Morrison Street, Suite 600, Portland, Washington 97204
Central Washington Office – Five Pine Station, 750 Buckaroo Trail, Suite 203, Sisters, Washington 97759

unions have been affected by many of these changes. Increasing competition, increasing regulation, increasing complexity of financial products and services have contributed to substantial changes in the way that many credit unions deliver services to their members. What has not changed – at all – is the fundamental difference between banks and credit unions. Credit unions continue to offer a cooperative, non-profit alternative to for-profit financial institutions.

Credit unions provide an enormous indirect benefit to their members. A recent study conducted by EcoNorthwest concluded that 3.58 million credit union members in Washington received direct economic benefits totaling $369 million in 2016. These direct benefits include cost savings and increased income resulting from the differences between credit union loan and account offerings and those of for-profit competitors. A copy of the study's summary is provided with this testimony. The study further indicates that this $369 million in direct benefit resulted in local spending of $413 million.

Conclusion

All of these factors point back to the inescapable conclusion that the primary objective of the exemption is to support state chartered credit unions as an ongoing non-profit vehicle for delivering financial services to Washingtonians. A second objective is making the state charter attractive as compared with the federal charter. Service to low-income Washingtonians is a side benefit of this approach; credit unions are proud of their record of providing services to all Washingtonians of any means. But service to low income members is not the objective of the tax exemption.

NWCUA urges the Commission to revise the inferred objectives to more accurately reflect both the text and context of the relevant statutes as stated above. Reference to low-income members as an inferred objective is inappropriate and unsupported. The preference should be continued, and there is no need for clarification.

P:\DOCS\NWCUA\01199\DOC\3QY4152.DOC

Portland Office – 121 SW Morrison Street, Suite 600, Portland, Washington 97204
Central Washington Office – Five Pine Station, 750 Buckaroo Trail, Suite 203, Sisters, Washington 97759