

## **Audit Technique Guide – Credit Unions – IRC Section 501(c)(14)**

### **Introduction**

These examination guidelines offer examination techniques in identifying and developing issues during the examination of organizations recognized as exempt from federal income tax under IRC Section 501(a) as an organization under IRC Section 501(c)(14) for credit unions.

These guidelines aren't all-inclusive. This discussion's purpose is to supplement the guidelines in other IRM sections. It's not to restrict you in identifying issues or using examination techniques not included here.

This discussion doesn't contain technical information on IRC Section 501(c)(14) organizations. Review the technical information in [IRM 7.25.14](#), Credit Unions and Mutual Reserve Funds .

### **Background**

Two types of credit unions are:

- Federal credit unions, administered by the National Credit Union Administration and described in IRC Section 501(c)(1) as federal instrumentalities.
- State chartered credit unions, in IRC section 501(c)(14)(A) and must be formed and operated under a state credit union law, without capital stock and have state defined characteristics, operate without a profit and for the mutual benefit of its members. (See Rev. Rul. 69-282, 1969-1 C.B. 155 clarified by Rev. Rul. 72-37, 1972-1 C.B. 152). State chartered credit unions offer savings accounts and loans to their members who may not be served by banks.

### **Mutual Reserve Funds**

IRC Section 501(c)(14)(B) states that exemption from federal income tax for corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit to provide reserve fund for, and insurance of shares or deposits in:

- Domestic building and loan associations
- Cooperative bank without capital stock organized and operated for mutual purposes without profit
- Mutual savings bank not having capital stock represented by shares
- Mutual savings banks under IRC Section 591(b)

Exemption under IRC section 501(c)(14)(B) requires an organization to insure shares of deposits in its member organizations and contains a specific restriction against issuing capital stock.

IRC Section 501(c)(14)(C) provides exemption for 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 Section 501(c)(14)(B)(i)-(iii). These organizations are exempt; however, only if 85 percent or more of the income is attributable to offering these reserve funds and to investments. If an organization meets section 501(c)(14)(B) requirements, the income percentage restriction of IRC Section 501(c)(14)(C) won't apply.

### **Examination Guidelines – General**

- Inspect the governing instruments and evaluate the actual operations to decide if the credit union is organized and operated for mutual purposes and without profit.

- Review minutes of the board of directors, newsletters and other publications for members to decide if the credit union's operated for mutual purposes.
- Review state laws dealing with organizations incorporated as credit unions to figure out whether the organization is compliant with state laws.
- Review the articles of organization and bylaws to figure out membership requirements. Decide whether the organization has a written, enforced common bond among their 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.
- Credit unions must receive the members' savings as a deposit or as payment for shares. Review the bylaws to determine the:
  - Maximum number of shares, which a member can hold
  - Conditions under which shares may be paid in, transferred, or withdrawn
  - Conditions under which deposits may be received and withdrawn
- Determine if each member is allowed one vote, regardless of the number of shares owned.
- Review activities to decide whether:
  - The organization meets the short term, unsecured credit needs of its members.
  - Loans are only for members of the credit union.
  - The credit union organization issues stock certificates.
- Decide if 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 or has unrelated business income.
- Sample review loan agreements to decide whether:
  - Loans are only to members.
  - Members submit applications in writing to the credit committee stating the purpose of the loan.
  - Loans are repayable in installments.
  - The credit union gives special consideration to officers or employees on loans or interest.

## **Inurement**

An organization exempt under IRC Section 501(c)(14) must be operated without profit and for the mutual benefit of members. The net earnings can't inure to the benefit of any member.

Examples of activities that may show inurement include:

- Issuance of stock certificates
- Loans to nonmembers
- Loans made without the approval of credit committee
- Payment of personal expenses of members or employees
- Write off loan to officers or employees

## **Examination Guidelines - Inurement**

- Inspect balance sheet to identify sources of outstanding stock, including preferred stock.
- Compare loan agreements to membership list.
- Review minutes of loan or credit committee for approval.
- Review cash disbursements to verify that expenses paid for officers and employees had a business purpose.

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

## **Unrelated Business Income (UBI)**

IRC Section 511(a)(2)(A) treats the two types of credit unions differently for unrelated business income (UBI):

- Federal credit unions described in IRC Section 501(c)(1) aren't subject to tax under IRC Section 511.
- A state-chartered credit union may have UBI subject to tax under IRC Section 511. Under Treas. Reg. 1.513-1(d)(2), for the conduct of a trade or business from which gross income is derived to be substantially related to the entity's exempt purposes, producing or distributing the goods or the services' performance from which the gross income must contribute to the accomplishment of those exempt purposes. Whether activities that produce gross income contribute to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved. To decide whether a credit union's activity is substantially related for UBI, examine each activity and all the facts and circumstances surrounding that activity to figure out the activity's relation to the organization's exempt purpose.

Treat income from the following income-producing activities as substantially related income and not UBI:

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

Treat income from the marketing of the following insurance products as well as certain ATM fees as UBI:

- Automobile warranties
- Dental insurance
- Cancer insurance
- Accidental death and dismemberment insurance
- Life insurance
- Health insurance
- ATM "per transaction" fees from nonmembers

Don't treat income from the following products if sold to members as UBI:

- 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.

Unless there is royalty arrangement (rather than payments for a credit union's services), treat all other insurance products including accidental death and dismemberment insurance as generally UBI.

See the following court cases for more on UBI of credit unions:

- *Bellco Credit Union v. United States*, 735 F.Supp. 2d 1286 (D. Colo. 2010)
- *Community First Credit Union v. United States*, No. 08-C-57, 2009 WL 2058476 (E.D. Wis. July 14, 2009)

### **Examination Guidelines -UBI**

- Review cash receipts journal 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 unrelated business income tax provisions in IRC Section 511.
- Review newsletters, pamphlets and other materials to decide if the credit union offers credit life and disability insurance as an added service to guarantee paying outstanding member loans.
- Review assets and liabilities to identify acquisition indebtedness. Review cash receipts journal to identify income from acquisition.