FTB NOTICE
California Franchise Tax Board - Legal Division

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FTB NOTICE 92-7

September 25, 1992

Control Number:
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SUBJECT: **1. Application of Revenue and Taxation Code Section 24405(c)**

2. Application of Alternative Minimum Tax To Credit Unions

1. METHODOLOGY FOR APPLICATION OF SECTION 24405(c)

BACKGROUND

Generally, credit unions are taxed as financial corporations. (Bank and Corporation Tax Law (B&CTL) section 23183; Appeal of State Employees Credit Union No. 1, Cal. St. Bd. of Equal., Dec. 13, 1961.) However, under B&CTL section 24405(a) a deduction is authorized for all income arising out of business activities for or with members. Prior to the adoption of B&CTL section 24405(c), California law provided that essentially all investment income of a credit union was nondeductible. (Woodland Production Credit Association v. Franchise Tax Board (1964) 225 Cal.App.2d 293.) Effective for income years beginning on or after January 1, 1988, B&CTL section 24405(c) provides generally that income from specified investments of "surplus member savings capital" is deductible. The statutory history of section 24405(c) makes clear, however, that investment income from "equity capital" remains taxable income of a credit union.[1]

The issue for consideration, therefore, is how to determine, from the total investment income of a credit union, the amount attributable to "surplus member savings capital" and the amount attributable to "equity capital." This issue is one of first impression since prior to the adoption of section 24405(c) there was no need to distinguish among the potential sources from which various investments were made. From whatever the source, the investment income was nondeductible, to the extent generated from nonmember activities, and thus included in the tax base, and deductible to the extent generated from member activities.

1/ The uncodified Section 2 of AB 1581, (Stats. 1987, Ch. 1465) provides:

It is not the intent of the Legislature to exempt, within the provisions of section 24405 of the Revenue and Taxation Code, "equity capital," as that term is defined in subsection (b) of section 14400 of the Financial Code.

NOTE: ((---)) = Indicates obsolete information.

It might be concluded from the identified legislative history, that all "equity capital" income, as distinguished from "surplus member savings capital" income, is intended to be in the taxable income base of credit unions. However, prior case law suggests that the nature of the underlying business transaction, rather than the source of funds, dictates whether income generated is taxable or deductible. (Woodland Production Credit Association v. Franchise Tax Board 225 Cal.App.2d 293, 300, *supra*; Long Beach Fireman's Credit Union v. Franchise Tax Board (1982) 128 Cal.App.3d 50, 54.) Further, the legislative history to AB 1581 indicates an intention to limit, not expand, prior case law relative to credit union tax liabilities. Therefore, it is necessary to identify a methodology, for consistent application by the affected industry and the department, to measure an appropriate amount of income as deductible and an appropriate amount of income as taxable, consistent with the legislative purposes in enacting the subject legislation.

The methodology set forth in this notice, a proration formula, produces a consistent result by which only such income as is generated from activities with nonmembers is subject to tax, and that income is further limited to account for the statutory deduction authorized for investment income from "surplus member capital" investments, regardless of the underlying nature of the activities which generate that income.

Using a methodology for apportioning investment income, exclusive of that generated by member transactions, between "surplus member savings capital" and "equity capital," is consistent with the approach taken to resolve many issues dealing with allocations between exempt and nonexempt income. For example, under B&CTL section 24425, it is necessary to allocate expenses of a taxpayer between taxable and nontaxable income, so as to disallow as a deduction that portion which is allocable to income not included in the measure of tax. The section has been held applicable to expenses incurred by credit unions, since a portion of credit union income is not included in the measure of tax. (Appeal of Unity Credit Union, Ca. St. Bd. of Equal., January 6, 1977.) As is true in this matter, no method for allocating expenses is statutorily provided. However, the proration formula used by the department to apportion indirect expenses between taxable and nontaxable income has been approved by the Board of Equalization and the California courts.[2] That methodology forms the basis for the methodology set forth below to prorate the defined interest income which requires proration.

REQUIRED METHOD

The methodology required allocates total investment income, as defined, in accordance with the following formula:

Surplus Member

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[2] Appeal of Pacific Associates, Inc., Cal. St. Bd. of Equal., February 2, 1976, CCH 205-387, P-H 13,101-T; Great Western Financial Corp. v. Franchise Tax Board 4 Cal.3d 1,6 [92 Cal.Rptr. 489].

$$\text{Total Investment Income} \times \frac{\text{Savings Capital}}{\text{Surplus member savings capital} + \text{retained earnings} + \text{reserves}} = \text{Section 24405(c) Deduction}$$

"Total Investment Income" is defined, for purposes of this notice, as the income of a credit union, less income otherwise qualifying as deductible under B&CTL section 24405(a); e.g., interest income from member loans.[3]

"Surplus member savings capital" is defined in B&CTL section 24405(c) as savings capital of credit union members which is in excess of the amount of savings capital which is loaned to members (in a member transaction).

"Savings capital" is defined in Financial Code section 14400(a) as payments made by members on shares, as set forth in the credit union's written savings capital structure policy, which is similar to bank savings accounts.

"Retained earnings" and "reserves" are also amounts identifiable from balance sheets and Financial Code requirements. Both items are included in "equity capital" as it is defined in Financial Code section 14400(c) as all consideration paid for membership, all entrance fees paid to become a member, all moneys held in the credit union's regular reserve account, all dues, fees or assessments paid by members other than fees charged in connection with share accounts or loans, and held in any contingency reserve account, and all retained earnings in a credit union's undivided profits account less all losses in excess of the credit union's regular reserve account.

In formulating the requirements of this notice, several factors were taken into consideration. First, there is no evidence of a legislative intent to change any law or practice relative to the direct allocation of member contributions to member capital. Thus, neither investment income from member transactions (loans), nor member capital contributions are factors required to be included in the proration formula.

Second, the foregoing approach makes the assumption that the source of capital for any particular investment option selected by a credit union cannot be directly traced. However, if direct tracing of either surplus member savings capital or equity capital to particular income generating assets is established, the income from such assets will be taxable or deductible based on the nature of the source of the investment.

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[3] Relative to reciprocal or central credit union investment income, a separate determination must be made in each case to establish whether that income is generated from a member or nonmember transaction. (See, Long Beach Firemen's Credit Union v. Franchise Tax Board, *supra*.)

Third, also recognized is the fact that only such equity capital as is not related to member transactions is to be included in the formula denominator. To include equity capital from member deposits (member savings capital) in the denominator would also require the inclusion of earnings from member transactions (loans) in the apportionable investment income amount for consistency. In certain cases, that could result in partial taxation of member income, despite the history of section 24405(c), which indicates a limitation on taxable income was intended by the legislature.

Fourth, since money is, as a practical matter, a fungible commodity, the source of funds representing any particular investment might be made up of dollars from members, retained earnings, nonmember loans to the credit union or reserve funds. Absent adequate direct tracing, it is necessary to use a proration formula to determine the allocation of investment income to the particular available sources from which the investments are made. In so doing it is appropriate to limit the ratio components to those relevant to implementing the legislative intent behind section 24405(c) - distinguishing between investment income generated from surplus member savings capital and from equity capital.

The method set forth above represents a reasonable effort to advance the purposes of section 24405(c), while retaining the prior legislative and judicial directive and authority to tax income generated from nonmember transactions. The intent of the legislation at issue cannot be viewed as intending to exempt credit unions from tax. If that were the legislative intent, full exemption from franchise tax would have been provided.[4] Substance has been given to the notion that the primary purpose of credit unions is to both promote thrift concerning its members and create a source of credit for these members. Substance has also been given to the apparent purpose of the 1987 legislation, which is to advance the ability of credit unions to pay competitive returns on member shares, keeping in mind that competitive savings rates of other financial institutions are generated fully with after-tax returns.

CONCLUSION

Without direct statutory authority for using a particular apportioning methodology, the reasonable approach of the administering agency, in this case the Franchise Tax Board, which is designed to accomplish the purposes of the statute at issue, will be implemented. (Appeal of Mission Equities Corporation, Cal. St. Bd. of Equal., January 7, 1975.) Accordingly, effective for all returns filed for income years beginning on or after January 1, 1988, compliance with the provisions set forth in this notice is required for a proper determination of tax liability.

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[4] In Great Western Credit Union v. Franchise Tax Board, *supra*, at pp. 4-5, the Supreme Court noted that deductions are to be narrowly construed against the taxpayer. (Citations omitted.) While other approaches to implementing the subject legislation might be advanced, as to the method set forth in this notice, it does produce an increased deduction, and thus reduced tax liability for all taxpayers with properly invested surplus member savings capital. Accordingly, other approaches which increase that deduction, or which produce an effective exemption from tax, will be rejected as exceeding the intended legislative benefits to be derived from the subject legislation.

2. ALTERNATIVE MINIMUM TAX

Under California law, for income years beginning on or after January 1, 1988, the imposition of the alternative minimum tax is in conformity with the federal law (Part IV of Subchapter A of Chapter 1 of Subtitle A of the Internal Revenue Code (IRC), except as otherwise provided in BCTL Chapter 2.5 (commencing at section 23400).

The alternative minimum tax is imposed under IRC section 55(a) and section 55(b) provides that "[i]f a taxpayer is subject to the regular tax, such taxpayer shall be subject to the tax imposed by this section... ." Under IRC section 55(c), the term "regular tax" is defined, with certain exception not applicable to this notice, by reference to taxes imposed by Chapter 1 of the IRC.

California incorporates IRC section 55(c) by reference, with modifications to reflect the authority under which regular taxes are imposed for California purposes. Under B&CTL section 23455(c), regular tax for California purposes means the amount of

"tax imposed under Chapter 2 (commencing with section 23101) or Chapter 3 (commencing at section 23501)... ".

State chartered credit unions are generally subject to tax under Chapter 2, section 23183. No state modifications or exceptions to this basic coverage of the alternative minimum tax provisions apply to exclude credit unions which are subject to a regular tax liability.

Therefore, to properly reflect its California tax liability, a credit union must include alternative minimum tax liability for all income years commencing on or after January 1, 1988, consistent with B&CTL Chapter 2.5 (commencing with section 23400).

DRAFTING INFORMATION

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