Are Tax Incentives needed for a viable Fifth Pillar?

Treasurer Wayne Swan has indicated his interest in creating a fifth pillar in the financial sector based around mutual credit unions and building societies to increase competition with banks. But the ability of that sector to grow is limited by its access to the capital required to meet APRA's minimum capital standards.

Credit Unions can, with minor exceptions, only generate capital in the form of shareholders funds by retaining earnings from their dealings with their member/owners. Prior to the early 1990s they were not taxed on this surplus (profit), and that remains the case in a number of overseas countries.

If nothing else, the application of corporate tax to credit unions reduces the after tax earnings available for retention and thus growth of the credit union's capital base and its lending ability. At first glance that looks fair – since banks are also subject to the same taxation.

However, the intricacies of the dividend imputation system make that simple comparison inappropriate. Banks can distribute franking tax credits arising from corporate taxation as franked dividends.

Use of these tax credits by bank shareholders means that corporate tax is essentially "washed out" and the profits of the bank ultimately taxed in total at the personal tax rate of the investor. To the extent that superannuation funds (with a tax rate of 15 per cent) are major bank shareholders, this suggests that the average total tax rate on bank profits is in the region of 15 per cent.

Mutual credit unions cannot, however, distribute franking credits to their owner/ member /shareholders who each hold one share of notional (eg $1) value. Consequently, the company tax paid by the credit union at the current rate of 30 per cent is not offset by the usage of the tax credits locked inside the organization.

That apparent tax disadvantage could be removed if some financial instrument were created which allowed credit unions to distribute franking credits to member/owners. But, for several reasons, this is no simple matter.

First, distribution of franking credits also involves imputation of taxable income to the recipient. Without the distribution of the retained earnings on which tax has been paid (which would undermine the mutual structure) credit union members on high tax rates might find themselves being imputed with notional income (but no cash flow) on which tax is payable and which exceeds the tax credits they have received.

Second, with each credit union member having one share, any pro-rata beneficial distribution of franking credits would be unrelated to the level of the member's involvement with, and contribution to the generation of the earnings of the credit union. There would be inappropriate incentives created for joining credit unions – not to use their services, but to receive some part of the franking credit distribution at the expense of other members.

Third, current credit union members are only partially responsible through their business dealings with the credit union for its accumulated shareholder equity. They largely “inherited” it as a form of financial and social capital from members past, and will cede it to future members when they leave. Thus, the issue is not so much about fairness to current members, but whether the tax system discriminates against this form of organizational structure, its ability to provide effective competition, and its ability to further grow the social capital involved.

The arguments outlined earlier suggest that this may indeed be the case, and that the tax treatment of credit unions is adverse and worth reviewing. Returning to a system of tax exemption is one possibility, but would probably tilt the playing field in the opposite direction.

It would, however, facilitate capital accumulation and growth by credit unions by removing the tax bite on retained earnings. And because Basel III is likely to reduce the ability of prudentially regulated institutions to use hybrid or debt type instruments as a funding source which also qualify as regulatory capital, other capital raising options for mutual credit unions may be even more restricted.

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