



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

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Identification Number:

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UIL: 501.14-00

Legend:

Credit Union        =  
State                 =

Dear                 :

This letter responds to the request of counsel for Credit Union dated March 9, 2005, for a ruling that the equity shares, that Credit Union issued solely to develop a means to raise additional capital to fully comply with National Credit Union Administration regulations, do not constitute "capital stock" within the meaning of section 501(c)(14)(A) of the Internal Revenue Code ("Code").

Facts

Credit Union is a state-chartered, federally-insured credit union incorporated in the 1930s. Credit Union operates on a nonprofit basis solely for the mutual benefit of its million plus members, virtually all of whom are employees of the state government, teachers, or members of their respective families. Credit Union provides traditional deposit, lending, and payment transaction services to its members, and it has several billion dollars in assets. Counsel for Credit Union represents that no individuals or entities participate in Credit Union's ownership or management other than its members,

and all of Credit Union's net earnings are either returned to members directly or retained for their benefit.

Credit Union was recognized as exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(14) because it is covered by a group exemption as a subordinate member of State's parent organization of the State-chartered credit unions.

Ownership in Credit Union is represented by share accounts authorized under State credit union act purchased by its members in exchange for funds invested in Credit Union (such share accounts are similar to bank deposit accounts). Dividends paid on share accounts are analogous to interest paid on bank accounts. Credit Union's share accounts are federally insured up to \$100,000 per insured account. Counsel for Credit Union represents that regardless of the amount or number of share accounts owned, each member of Credit Union has only one vote on all matters on which members are entitled to vote. Counsel further represents that the one-member, one-vote rule is mandated by State law and Credit Union's organizational documents. If Credit Union liquidates, its share accounts are subordinate to the claims of Credit Union's creditors. Such share accounts are characterized as liabilities on Credit Union's balance sheet, consistent with the treatment of such accounts under generally accepted accounting principles.

Counsel for Credit Union represents that Credit Union is subject to supervision and regulation by State, as well as by the National Credit Union Administration ("NCUA"). In 2000, NCUA promulgated certain prompt corrective action regulations ("PCA Regulations") implementing provisions of the Federal Credit Union Act. In order to maintain its current operations under PCA Regulations, Credit Union is required to maintain a minimum ratio of net worth to total assets of seven percent. However, counsel for Credit Union represents that PCA Regulations currently recognize only Credit Union's retained earnings as qualifying net worth. Thus, to the extent that Credit Union's total assets grow faster than its ability to add to its retained earnings, PCA Regulations make it more difficult for Credit Union to satisfy the capital requirements. As a result, counsel for Credit Union represents that Credit Union needs an alternative capital instrument to raise additional capital. At this time, however, neither Congress nor NCUA recognize any such alternative capital as part of a credit union's net worth under PCA Regulations.

Counsel for Credit Union represents that because alternative capital does not receive regulatory recognition until it exists in a form that can be studied, Credit Union issued \$1,000,000 in share certificates ("Equity Shares") to one of its members in 2001. Furthermore, counsel represents that Credit Union issued the Equity Shares solely to develop a means to raise additional capital to fully comply with PCA Regulations. Counsel for Credit Union anticipates that, in the near future, there will be reconsideration of the current restrictions preventing Equity Shares from being taken into account in the determination of net worth under PCA Regulations.

Credit Union's Equity Shares constitute share accounts under the State credit union act. Although dividends on the Equity Shares are not guaranteed, Credit Union intends to pay them at a rate equal to the dividend rate on the outstanding stock of the Federal Home Loan Bank of Atlanta. Credit Union may defer interest payments on Equity Shares without charge.

Counsel for Credit Union represents that although Equity Shares do not have a stated maturity date, (a) Credit Union may call Equity Shares at any time, and (b) the holder is entitled to redemption of Equity Shares only after five years' written notice and only if Credit Union will immediately thereafter be in compliance with all applicable regulatory capital requirements. Moreover, counsel represents that the call and redemption price is the amount of the investment.

Counsel for Credit Union further represents that Equity Shares are subordinate to all obligations and share accounts of Credit Union. Equity Shares cannot be transferred without the prior consent of Credit Union. Additionally, counsel represents that a holder of Equity Shares has no conversion rights, no restrictions against dilution, and no preemptive rights to purchase additional Equity Shares.

Counsel for Credit Union also represents that Equity Shares do not grant to their holder or holders any voting rights with respect to Credit Union. Moreover, counsel represents that the holders only have rights to receive interest payments and the amount received on the redemption of Equity Shares by Credit Union.

Counsel for Credit Union represents that the Administrator of the State credit union division granted regulatory approval to the issuance of Equity Shares in 2001.

### **Ruling Requested**

Counsel for Credit Union seeks a ruling that Equity Shares do not constitute capital stock within the meaning of section 501(c)(14)(A) of the Code.

### **Law and Analysis**

Section 501(a) of the Code provides that an organization described in section 501(c) of the Code is exempt from federal income tax.

Section 501(c)(14)(A) of the Code provides for exemption from federal income taxes for "[c]redit unions without capital stock organized and operated for mutual purposes and without profit."

In La Caisse Populaire Ste. Marie v. United States, 77-1 USTC P 9137 (D.N.H. 1976), aff'd, 563 F.2d 505 (1<sup>st</sup> Cir. 1977), the Tax Court determined that the taxpayer, whose "credit union" status was at issue in the case, was without capital stock for

purposes of section 501(c)(14)(A). The court reasoned that there was no “capital stock” where the shares owned by the members could not appreciate in value, where the cost of a share -- \$5.00 -- was the same price as when the taxpayer was established in the 1930s, and where the taxpayer would buy back any share for \$5.00, the purchase price for the share, resulting in no gain or loss. The court, citing a United States Attorney General Opinion, 31 Op. Att’y Gen. 176 (1917), concluded that this taxpayer’s structure was the same structure which was initially approved as being “without capital stock” so that credit unions could be exempted under the general exemption for co-operative institutions.

In United States Attorney General Opinion, 31 Op. Att’y Gen. 176 (1917), the U.S. Attorney General opined that credit unions, as they exist under Massachusetts law, were in substance and in fact the same as cooperative banks, and were thus exempt from federal income tax under section 11 of the September 8, 1916 income tax law. Since no certificate of stock is issued to the shareholder in a credit union, the Attorney General Opinion provided that it seems clear that the term “capital stock” as used in connection with credit unions is in no sense similar to the accepted business meaning of that term, which Congress doubtless had in mind when the words “without capital stock” were inserted. The Attorney General noted that while dividends are paid on shares of stock in a credit union, it is in reality the same as paying interest on deposits. Moreover, the Attorney General stated that at the annual meeting of the association each member (shareholder or depositor) has but one vote, and no member can vote by proxy. Additionally, at this meeting the members may, upon recommendation of the board of directors, declare a dividend from income which has been actually collected during the fiscal year, after certain deductions have been made, but as a practical matter the dividend simply takes the place of interest. Thus, the Attorney General concluded that shareholding is merely a means of accumulating savings and is one of the privileges of membership in the credit union.

Counsel for Credit Union represents that Credit Union is organized and operates as a credit union for the mutual benefit of its membership. Therefore, the sole issue we must determine is whether the Equity Shares constitute capital stock within the meaning of section 501(c)(14)(A) of the Code. In determining that “capital stock” under the respective state laws did not constitute capital stock for purposes of section 501(c)(14)(A), the Tax Court and the Attorney General have focused upon the fact that shareholding in a credit union was merely a means of saving in that there was no possibility of appreciation in a capital investment in the credit union and that such capital stock did not grant a participating equity interest in the credit union.

Ownership in Credit Union is represented by share accounts authorized under State credit union act purchased by its members in exchange for funds invested in Credit Union (such share accounts are similar to bank deposit accounts). Dividends paid on share accounts are analogous to interest paid on bank accounts. Counsel represents that Credit Union is only issuing Equity Shares in order to satisfy the more stringent capital requirements imposed by NCUA’s PCA Regulations. Equity Shares

provide only for discretionary interest payments until their redemption. Moreover, counsel represents that the call and redemption price is the amount of the investment. Consequently, counsel represents that the holders only have rights to receive interest payments and the amount received on the redemption of Equity Shares by Credit Union.

Counsel for Credit Union also represents that Equity Shares do not grant to their holder or holders any voting rights or other participation rights in the management of Credit Union. In addition, counsel represents that Equity Shares are subordinate to all obligations and share accounts of Credit Union; equity Shares cannot be transferred without the prior consent of Credit Union; and a holder of Equity Shares has no conversion rights, no restrictions against dilution, and no preemptive rights to purchase additional Equity Shares.

### **Ruling**

Based on the information included in the submission and the representations of counsel, we conclude that Equity Shares do not constitute capital stock within the meaning of section 501(c)(14)(A) of the Code because they are merely a means of saving in that they grant neither a participating equity interest in Credit Union nor any participation in the management of Credit Union. Accordingly, Credit Union's tax-exempt status under section 501(c)(14)(A) is not adversely affected by Credit Union's issuance of Equity Shares.

This ruling is based on the understanding that there will be no material changes in the facts and representations upon which it is based. Except as we have ruled herein, we express no opinion as to the tax consequences of the transactions under other sections of the Code and Income Tax Regulations.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited by others as precedent.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,  
/S/

Robert C. Harper, Jr.  
Manager, Exempt Organizations  
Technical Group 3

Enclosure  
Notice 437