

Tax Reform as Reported by the Conference Committee

On December 20, 2017, the Congress passed the House-Senate tax reform conference committee of the compromise “Tax Cuts and Jobs Act” (TCJA), which would cut taxes by roughly \$1.5 trillion over ten years and would make significant changes to and simplify our nation’s tax laws. The President is expected to sign the bill into law the first week of January 2018.

The compromise bill would not alter or eliminate the credit union federal income tax status in any way! This is a huge victory for the credit union movement and an affirmation by the United States Congress of the value proposition of the credit union difference. This was accomplished against the unified opposition and lobbying force of America’s banks and their \$17 trillion in assets!

Credit Union Income Tax Status

While many other credits, deductions and tax expenditures would be eliminated or scaled back by the TCJA, this bill makes no change to the federal tax exemption for state and federally chartered credit unions. We attribute the preservation of the credit union tax status to an understanding on the part of tax writers that credit unions continue to fulfill their statutory mission to promote thrift and provide access to credit for provident purposes through a cooperative, not-for-profit, structure.

In 2016, credit unions provided total member benefits equal to \$10.2 billion. In addition, bank customers saved about \$4 billion in 2016 from more favorable pricing due to the presence of credit unions in their local markets. The TCJA is indeed an affirmation of the good work and positive impact that credit unions make in the communities they serve.

Unrelated Business Income Tax

All credit unions are exempt from the federal corporate income tax under §501(c)(1) of the Internal Revenue Code for federally-chartered credit unions and under §501(c)(14)(A) for state-chartered credit unions. Nevertheless, income at state-chartered credit unions that the Internal Revenue Service (IRS) deems to be unrelated to the credit union’s tax-exempt purpose is subject to taxation under §511-513; federal credit unions are not subject to UBIT requirements because they are instrumentalities of the federal government and subject to restrictions on activities imposed by Congress.

Income that is subject to UBIT is defined as any net income derived from any “unrelated trade or business” – defined as “activity not substantially related to organization’s exempt purpose.” Income is “substantially related” if it “contributes importantly to accomplishment of the organization’s exempt purposes.” UBIT was designed to prevent unfair market competition from tax-exempt entities against for-profit entities.

The IRS requires that state-chartered credit unions file annual Form 990s, like most other tax-exempt entities. These credit unions must also file a Form 990-T (UBIT Form) if the tax-exempt entity has \$1,000 or more of unrelated business taxable income to report.

The bill would require tax-exempt organizations currently subject to UBIT (including state-chartered credit unions) to pay UBIT on certain employee fringe benefits, namely transportation and parking benefits, as well as on-site gyms and athletic facilities. In this legislation, any taxpaying entity is no longer allowed to deduct these and other employee benefits. The bill places this new burden on exempt organizations and shall apply to amounts paid or incurred after December 31, 2017. The corporate deduction for business-related entertainment expenses would also be eliminated. Meals provided to employees would continue to be deductible until 2025. When

provided by a tax-exempt entity, such fringe benefits would be considered unrelated business income and therefore taxable.

CUNA remains concerned that this vague language could be interpreted to apply to association membership dues.

With regard to the above paragraph, CUNA also seeks clarification from the IRS as to whether a not-for-profit organizations that are already deducting these expenses against its UBIT income would then no longer be able to do so. This would then increase its UBIT income and taxes. This bill does not appear to make these provisions as taxable as UBIT standing alone.

Under current law, when a tax-exempt organization operates more than one unrelated trade or business activity, losses generated by one business may be used to offset income derived from another. Under the TCJA, losses generated by one unrelated trade or business could not be used to offset income derived from another unrelated trade or business. This provision would result in an increase in unrelated business taxable income. A net operating loss (NOL) deduction would be allowed only for the entity where the income loss originated. This provision is effective for taxable years beginning after December 31, 2017. Under a transition rule that has been added to the bill, net operating losses that occurred before January 1, 2018 and that are carried forward to a taxable year beginning on or after such date would not be subject to this provision.

The original Senate bill included provisions that would have imposed a new Unrelated Business Income Tax (UBIT) requirement on credit unions and the trade associations like those that represent credit unions. This provision would have imposed UBIT on logo and royalty income that many credit unions and others depend upon... income that in reality is in direct relation to their exempt status. CUNA opposition resulted in this provision being eliminated from the Senate-passed bill.

There are other provisions addressing not-for-profit entities in the TCJA. The legislative language, as well as Congressional intent, need further clarification before CUNA can comment on those provisions here.

Deferred Compensation

Originally, both House and Senate tax bills would have eliminated 457 deferred compensations plans. Both chambers removed these provisions and the conference committee decided to not eliminate these compensation plans.

Executive Compensation

The TCJA would impose an excise tax on certain executive compensation provided by tax-exempt organizations. Tax-exempt entities would be required to pay a 21% excise tax on the five highest paid employees' compensation that individually exceed \$1 million annually. The excise tax would be paid by the employer on amounts that exceed \$1 million annually and would be effective for tax years beginning after 2017. This provision is designed to create parity with respect to for-profit entities that can only deduct the first \$1 million of each individual employee's compensation.

The definition of compensation includes cash and the cash value of most benefits. "Roth" retirement plan contributions are not included, nor are 457(b) deferred compensation plans. However, somewhat different treatment is defined for 457(f) plans, also known as "ineligible" deferred compensation plans. For these plans, the bill treats the definition of compensation as including plan amounts paid when the rights to the remuneration are no longer subject to a substantial risk of forfeiture. Thus, the 21 percent excise tax can apply to the value of remuneration that is vested in the plan (and any increases in its value or vested remuneration), even if it is has yet to be received.

In addition, this legislation has a huge parity problem between existing for-profit and not-for-profit employee contracts with regard to the not-for-profit 21 percent excise tax and the deductibility of corporate executive compensation. This bill exempts from deductibility limits existing corporate executive compensation contracts by “grandfathering” in “for-profit” executive contracts in effect on or before November 2, 2017. No such provision is included for not-for-profit employee contracts. We expect a tax technical corrections bill to be considered in Congress in 2018 and CUNA will actively advocate for not-for-profit parity with for-profit businesses regarding employee contract parity and the "grandfathering" of existing contracts.

Retirement Accounts

Early tax reform discussions on Capitol Hill included consideration of significant rollbacks in the availability of pre-tax contributions to these retirement plans to raise revenues in the legislation. Massive pushback from many sectors convinced Congress to back off such limits. This bill would make minor changes around the edges of these savings products but would not make substantive changes that would adversely affect Americans saving for retirement. Therefore, credit unions could expect continued demand for IRAs on their balance sheets and off-balance sheet investment services.

Mortgage Interest and Property Tax Deduction

As part of fulfilling the credit union mission, many credit unions originate mortgages, refinance mortgages, and provide home equity loans to their members. During early tax reform discussions, tax writers considered eliminating the mortgage interest deduction and the property tax deduction for homeowners in order to help "payfor" other tax cuts. Ultimately, the Senate and House decided to primarily expand on existing limitations on these deductions.

The compromise legislation preserves the mortgage interest deduction with some modifications. For homeowners with existing mortgages, there would be no change to their mortgage interest deduction.

For taxpayers with new mortgages on a first or second home, the mortgage interest deduction would be capped on NEW (acquired indebtedness after December 15, 2017) acquisition debt on a first or a second home. The new deduction of \$750,000 is a combined limitation. However, this provision ends on January 1, 2026. In addition, the deduction would be capped at indebtedness on homes less than \$375,000 in the case of married taxpayers filing separately. Beginning in 2026, the mortgage deduction would be capped for home acquisition costs up to \$1 million, and half that amount for married taxpayers filing separately. This latter provision would apply regardless of when the mortgage was taken by a taxpayer.

Unfortunately, the compromise bill would eliminate the deduction for interest on home equity loans. However, similar to the mortgage interest deduction, this provision would be modified in 2026 to allow for the deduction of home equity debt.

Regarding refinancing, “acquisition indebtedness” is defined as indebtedness that is incurred in acquiring or constructing a residence. Specifically, the term also includes indebtedness from the refinancing of other acquisition indebtedness but only to the extent of the amount (and term) of the refinanced indebtedness. For example, if the taxpayer incurs \$400,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to \$150,000, the taxpayer’s acquisition indebtedness with respect to the residence cannot thereafter be increased above \$150,000 (except by indebtedness incurred to substantially improve the residence).

The deductibility of state and local income and property taxes also affects the attractiveness and affordability of home mortgage products offered by credit unions. In this final bill, individual taxpayers would be able to deduct up to \$10,000 (\$5,000 for married taxpayer filing a separate return) in such taxes annually on the itemized portion of their tax returns.

This provision would apply to amounts paid between 2018 and through the end of 2025.

This provision may slightly retard long-term home price appreciation.

It is important to note that the deduction of mortgage interest and property taxes, along with other deductions like charitable contributions, are only attractive insofar as one's deductions exceed the amount of the standard deduction. The TCJA would double the standard deduction. If enacted into law, even those with average sized mortgages might choose the standard deduction in lieu of itemizing the home interest they have paid, depending on whether their itemized deductions will lower their tax bill more than simply taking the new doubled standard deduction. On the other hand, existing tax law has a provision referred to as the "Pease" limitation, which limits itemized deductions for wealthier taxpayers. This legislation would eliminate this limitation in tax years 2018 through 2025.

New Markets Tax Credit

The House-passed tax bill would have eliminated the new markets tax credit. This credit is important to the Community Development Financial Institutions (CDFI) community. Under this House provision, no additional new markets tax credits would have been allocated after 2017 but credits that would have already been allocated could have been used for seven years. The CDFI Fund administers the New Markets Tax Credit program, which provides tax credits to Community Development Entities (CDEs), which in turn provide the tax credits to entities which invest in the CDEs.

On the other hand, the Senate-passed tax bill would not have eliminated the New Markets Tax Credit. Fortunately, the Senate position prevailed in the conference committee and this credit would not be eliminated.

Small Business Loan Interest Deductibility

Credit unions play a key role in helping solve the credit crunch facing America's small businesses. When other lenders have been forced to pull back lines of credit, credit unions have continued to lend and they have the capacity to do more. Unfortunately, credit unions are unnecessarily restricted from similarly alleviating the credit crunch that grips America's small businesses by an arbitrary statutory cap on business lending of 12.25% of a credit union's total assets. Credit unions have been subject to this statutory cap for nearly 20 years. However, there is no economic or safety and soundness rationale for this cap. Prior to 1998, there was no business lending cap. Credit unions have a long history of offering their members loans to help start small businesses. In fact, credit unions have been offering business loans to their members since their inception. The average credit union business loan is approximately \$200,000; this means that credit union business loans are used not only to start new businesses but also help credit union members make payroll, stay in business, expand their businesses and stimulate the economy. Part of making these small member business loans attractive for credit union members is the federal tax deductibility of the interest on these loans.

The TCJA would preserve the deductibility of interest on smaller business loans, like the ones credit unions make. In general, small businesses with average annual gross receipts of less than \$25 million would be exempt from new interest deductibility rules in this bill.

Personal Tax Rates and Deductions

This massive overhaul of the tax code would affect credit union members in various ways by three major changes: reductions in tax rates, a doubling of the standard deduction, and elimination or curtailment of many itemized deductions and credits. The tax rate reductions for income levels of most credit union members would provide significant decreases in total tax bills. This legislation would also reduce the attractiveness of itemizing deductions for many credit union members. Some of the itemized deduction changes which would directly affect members' use of credit unions, are discussed in more detail below.

The net income increases that most households will enjoy from this legislation, after a long period of real wage stagnation, would likely make a difference in many households' spending plans. Some of that spending will likely involve increased consumer loan demand at credit unions.

The bill would sharply reduce itemized deductions by middle-income households. This is due both to the doubling of the standard deduction and elimination or reductions of deductions. According to the Tax Policy Institute, under current rules less than half of tax filers with annual incomes under \$100,000 itemize, while the vast majority of those with higher incomes do so. If this tax legislation is enacted, fewer taxpayers with incomes below \$100,000 would itemize, and many with incomes between \$100,000 and \$150,000 would likely find it no longer worthwhile. That encompasses the vast majority of credit union members.

Effects on Economic Growth

Proponents of this tax overhaul suggest that tax simplification and reductions would spur economic activity. That is very likely to happen, but the size of the effect is subject to debate. There would also be some dislocations as sectors whose tax preferences are reduced grow more slowly and other industries enjoy faster growth due to tax rate reductions. The net effect would likely be to strengthen the current economic expansion and delay the next recession. Of course, the bill would also increase the national debt over the next decade. Faster growth would recover some of the \$1.5 trillion.

Conclusion

This bill is a huge win for credit unions and is an affirmation by Congress that the credit union system is loyal to its founding principles and serves a vital function in promoting thrift and providing essential financial services to a large segment of the American population that is considered underbanked. We expect a tax technical corrections bill to be considered in Congress in 2018 and CUNA will again aggressively defend this unique tax status afforded credit unions.

Note: This summary should not be considered as formal tax advice and should not be used as an alternative to seeking professional legal tax advice. In addition, this new law will be subject to future interpretation by the Treasury Department and the Internal Revenue Service. Also, legislative language, as well as Congressional intent, need further clarification before CUNA can comment on certain bill provisions. Finally, there are other provisions addressing not-for-profit entities in the TCJA. The legislative language, as well as Congressional intent, need further clarification before CUNA can comment on those provisions here.