Credit Union Interests in the Senate’s “Tax Cuts and Jobs Act” (as introduced)

Background
On November 9, 2017, Senate Finance Committee Chairman Orrin Hatch (R-UT) released a “conceptual mark” of the “Tax Cuts and Jobs Act” (TCJA), legislation that would cut taxes by roughly $1.5 trillion over ten years. Differing in details but sharing the same title as the House bill, the Senate Finance Committee will begin a multi-day markup on its version of the legislation beginning November 13, 2017. Senate floor consideration of this bill will occur the week of November 20, 2017. If passed out of the Senate, both House and Senate negotiators will attempt to reconcile their differing tax bills. During the week of December 18, 2017, CUNA expects House and Senate passage of the “reconciled” tax reform conference report.

Congressional leaders plan to have the legislation signed into law by the president before Christmas. It is also important to remember that government funding expires on December 8, 2017. This deadline will necessitate separate legislative action to avoid a government shutdown. This may interfere with the current Congressional tax reform timeline.

As referred to earlier, this “conceptual mark” is not actually legislative bill text. It is written in a narrative format, in part because the Constitution requires all revenue bills to originate in the House of Representatives. Therefore, it cannot be given a Senate bill number yet. Rather, Senate practice has been to take a revenue-related bill passed by the House and sent to the Senate, then strip out all of the House bill text and insert the Senate’s revenue legislative text. This also means that we don’t have enough details yet, as we would if we had legislative text, to provide a completely thorough and detailed description of every provision in the Senate “bill.”

Key Points

- No change would be made to the credit union federal income tax status.
- The TCJA would make changes to Unrelated Business Income Tax (UBIT) requirements that could impact credit unions.
- There would be an excise tax on certain non-profit executive compensation.
- There would be no substantive changes to retirement savings rules.
- The TCJA would maintain the current mortgage interest deduction but eliminate deductions for interest on home equity loans as well as disallow property tax deductions. However, the standard deduction would nearly double.
- The deductibility of business loan interest would be limited, but loans made to certain small businesses would be exempt from new rules.
Credit Union Income Tax Status

While many other credits, deductions and tax expenditures would be eliminated or scaled back by the TCJA, the mark 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.

A background description of the mark by the Joint Committee on Taxation does repeat a sentence it has often included in its publications that, "While significant differences between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time." This reflects a lack of knowledge by the Joint Committee on Taxation of the credit union difference, a problem that CUNA staff have tried to correct by meeting with and attempting to educate the Committee on the inaccuracy of that statement.

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. This mark 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 unrelated business taxable income to report.

There are a number of provisions in the Senate mark related to tax-exempt organizations. Without legislative text, we cannot be completely certain of the applicability of certain provisions to credit unions. First, there is a provision would apply UBIT to the sale or licensing (including royalties paid) by a tax-exempt organization of its name or logo (including any related trademark or copyright). This provision would be made effective for taxable years beginning after December 31, 2017. Second, there is a provision related to the modification of taxes on excess benefit transactions (intermediate
sanctions). Today, certain employees at tax-exempt entities must pay an excise tax up to 25 percent on their total compensation (salary and benefits). The mark would expand on current law by adding a 10 percent excise tax to the employer for each employee subject to the excise tax. The employer could avoid this tax if it can prove that the compensation package is “reasonable.” This provision would be effective for taxable years beginning after December 31, 2017. Third, when a tax-exempt entity operates more than one unrelated business, business losses from one business may be used to offset income from another. This provision would prohibit this practice. This provision would be effective for taxable years beginning after December 31, 2017.

**Executive Compensation**

Currently, taxpaying employers can deduct “reasonable” executive compensation for their three most highly paid executives. The amount that is deductible is up to $1 million per executive in compensation and benefits annually. The Senate mark would subject tax-exempt organizations to a 20 percent excise tax on total compensation in excess of $1 million paid to any of its five highest paid employees. This proposal would apply to taxable years beginning after December 31, 2017.

This 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.

**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. The Senate mark makes minor changes around the edges of these savings products but does 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, Senate tax writers considered eliminating the mortgage interest deduction for homeowners in order to help “pay for” other tax cuts. Ultimately, the Senate Finance Committee decided to preserve the home mortgage interest deduction for existing and new mortgages so mortgage holders would continue to be able to deduct the interest on the portion of their principal residences that are valued at less than $1 million. However, interest on home equity loans would no longer be a deductible expense.

The deductibility of state and local property taxes also effects the attractiveness and affordability of home mortgage products offered by credit unions. Under this mark, individual taxpayers would no longer be able to deduct personal (nonbusiness) property taxes on the itemized portion of their tax returns. This provision would be effective for tax years beginning after December 31, 2017. This too would 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 Senate mark would nearly 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. The Senate mark would eliminate this limitation, beginning in tax years after 2017.

**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.

This mark 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 $15 million over the previous three taxable years would be exempt from new interest deductibility rules. This provision would be effective for tax years beginning after 2017.

**Personal Tax Rates and Deductions**

Credit union members would be affected in various ways by three major changes: reductions in marginal tax rates, a near 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. The TCJA 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 TCJA lowers individual tax rates for the less affluent by expanding the zero tax bracket and maintaining the 10 percent bracket. In addition, there would be a top bracket of 38.5 percent. Most households would face lower marginal tax rates under this proposal. The standard deduction would increase from $6,350 to $12,000 for individuals, $12,700 to $24,000 for married couples, and $9,300 to $18,000 for single parents. Also, the child tax credit would increase from $1,000 to $1,650 and allow more parents to claim the credit by lifting the existing income caps.

Combined with the increase in the standard deduction, a married couple with an annual income of $60,000 (approximately the national median) and taking the standard deduction would enjoy a tax reduction of 25% or around $1,200, from $4,900 to $3,700. That equates to a roughly 2.5% increase in take-home pay (after federal income and payroll taxes). For couples earning less than $60,000 a year, the proportional tax reductions are much greater, and the proportional after-tax income gains are a bit lower. In terms of percentage increase in take home pay, the greatest benefits—increases of over 4%—go to married-couple households earning between $250,000 and $350,000, and above $700,000. In general, compared to the House bill, the Senate bill lowers tax savings (and after-tax income gains) for those earning less than $40,000 and for those earning between $100,000 to $250,000 - and it increases tax savings (and after-tax income gains) for those earning more than $250,000.

In any case, these net income increases, after a long period of real wage stagnation, and the accompanying publicity 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 legislation would sharply reduce itemized deductions by middle-income households. This is due both to the near doubling of the standard deduction and elimination or lowering of deductions such as the state and local income and property tax 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 legislation were enacted in its current form, very few 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 the bill 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 (home ownership, electric cars, and many others) 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, with the economy already running near full employment, additional fiscal stimulus would raise the specter of more obvious inflation pressures and (consequently) a more aggressive Federal Reserve approach to market interest rate increases. Additionally, the legislation would increase the national debt over the next decade. Faster growth would recover some of the $1.5 trillion.

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