Credit Union Interests in H.R. 1, the Tax Cuts and Jobs Act (as introduced)

Background

On November 2, 2017, House Ways and Means Committee Chairman Kevin Brady (R-TX) unveiled a 429-page tax reform bill. H.R. 1, the "Tax Cuts and Jobs Act", cuts taxes by roughly $1.5 trillion over ten years and makes significant changes to and simplifies our nation's tax laws.

Key Points

- H.R. 1 would make no change to the credit union tax status.
- The legislation would make changes to Unrelated Business Income Tax (UBIT) requirements that could impact credit unions.
- The legislation would impose an excise tax on certain non-profit executive compensation.
- The legislation would not substantively change retirement savings rules.
- The legislation would make changes to the mortgage interest and property tax deductions, and would double the standard deduction.
- The legislation would severely limit the deductibility of business loan interest, but would exempt loans made to certain small businesses.

Credit Union Income Tax Status

While many other credits, deductions and tax expenditures would be eliminated or scaled back by H.R 1, the legislation 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. This bill 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.

H.R. 1 would require tax-exempt organizations (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 same employee benefits. The bill places this new burden on exempt organizations and shall apply to amounts paid or incurred after December 31, 2017.

Executive Compensation

H.R. 1 would impose an excise tax on certain executive compensation provided by tax-exempt organizations. Tax-exempt entities would be required to pay a 20% excise tax on the first five employees' compensation that individually exceeds $1 million annually. The definition of compensation includes the value of employee benefits except for payments to a tax-qualified retirement plan and amounts that are excludable from the employee's gross income. 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 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 new legislation 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, tax writers considered eliminating the mortgage interest deduction for homeowners in order to help "payfor" other tax cuts. Ultimately, they decided to modify – but not eliminate – the deductibility of interest on these loans.

H.R. 1 would preserve the home mortgage interest deduction for existing mortgages so existing 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. Interest on existing home equity loans of up to $100,000 would continue to be deductible; but, for new homes bought after November 2, 2017, only the interest on the mortgage amount of up to $500,000 would be deductible. Further, this deduction would be available on only one principal residence.

Under H.R. 1, interest on home equity loans incurred after November 2, 2017, would not be deductible. With respect to the refinancing of these mortgages, if the home debt was incurred prior to November 2, 2017, the refinanced product would be treated as incurred on the same date that the original debt was incurred for the purposes of determining the amount of interest allowed to be deducted.

These new limitations on mortgage interest deductibility would affect credit union mortgage lending, but the impact will be limited. The average first mortgage loan granted by credit unions currently stands at $197,000. And even for new mortgages of more than $500,000, interest on the first $500,000 of the loan would remain deductible. For smaller mortgages, there would also be the impact of fewer members itemizing deductions, so deducting mortgage interest would play less into a homeownership decision. The net effect of these changes would likely not be a noticeable reduction in the number of mortgages that credit union members hold. However, by increasing the after-tax cost of buying a home, we can expect slower home price appreciation going forward, and perhaps even a small decline in home prices over the next year before modest appreciation resumes.

The deductibility of state and local property taxes also effects the attractiveness and affordability of home mortgage products offered by credit unions. Under this bill, taxpayers would be allowed to deduct up to $10,000 in property taxes on the itemized portion of their tax returns. This provision would be effective for tax years beginning after December 31, 2017. The impact of this change would also be felt by relatively few credit union members, those with higher-priced homes in local jurisdictions with high-property taxes. 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. H.R. 1 would double the standard deduction. If the legislation were 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. H.R. 1 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 legislation would severely curtail the deductibility of interest on certain business loans. However, smaller business loans, like the ones credit unions make, are mostly protected. Under H.R. 1, small businesses – those with average annual gross receipts of $25 million or less – would be exempt from the interest limitation rules in the bill. 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 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 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 bill would replace the current seven tax brackets (ranging from 10% to 39.6%) with four, from 12% to 39.6%. Most households would face lower marginal tax rates under the proposal. 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 even greater, although the proportional after-tax income gains are similar. In terms of percentage increase in take home pay, the greatest benefits—increases of over 4%--go to married-couple households earning between $100,000 and $150,000, and around $1 million.

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 doubling of the standard deduction and elimination or reductions of deductions (state income taxes, medical expenses, high-balance mortgage interest, etc.). 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, the legislation would also increase the national debt over the next decade. Faster growth would recover some of the $1.5 trillion.

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