NATIONAL TAXPAYERS UNION

Issue Brief

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Due to Growing Concerns, Congress Should Take a Fresh Look at the Merits of the Credit Union Tax Exemption

Designated as 501(c)(1) not-for-profit institutions, credit unions are exempt from the corporate income tax and generally most state income taxes. Congress granted these institutions an exemption in the 1930s so they can serve members within a "well-defined local community, neighborhood, or rural district" or who shared a "common bond of occupation or association," who were of modest means, and could not access service at traditional banks. However, over the last several decades, some larger credit unions have begun to more closely resemble traditional banks.

According to the National Credit Union Administration (NCUA), there are more than 5,200 federally insured credit unions in the United States operating as not-for-profit institutions. Within the $1.5 trillion credit union industry, at least 315 credit unions have assets north of $1 billion, representing about 5 percent of credit unions, but more than two-thirds of the assets of the entire industry. According to data from NCUA, nearly all membership and asset growth of the credit union industry as a whole has occurred just within credit unions of this category.

Key Facts:

Evidence suggests large credit unions have abandoned their original, tax-exempt purpose in order to directly compete with tax-paying community banks.

Congress should review and retool the credit union tax exemption to make the tax code fairer and more efficient.

If preserved in its entirety, the credit union tax exemption's revenue impact will be $22 billion over the next decade.

National Taxpayers Union has written extensively on this subject and noted that a few large credit unions have relaxed their field of membership requirements from those who share a common bond to virtually anyone and everyone. In many respects, these few large institutions are directly competing as non-profits with for-profit community banks for similar customers, which falls in conflict with the original intent of Congress under the Federal Credit Union Act of 1934.

Different tax treatment of depository institutions has its merits, so long as these institutions are abiding by the rules of the road. Though the vast majority of credit unions are small and sticking to Congressional intent, a few large credit unions may be stretching their advantages to compete directly with banks.

It is entirely appropriate for Congress to periodically review and reform all sections of the federal tax code. In 2020, lawmakers should focus their attention on the tax treatment of large, bank-like credit unions.

Using their Tax Advantage to Purchase Tax-Paying Institutions

The principle of "tax neutrality" should be the goal of any country's tax code. In theory, it's a straightforward concept: the tax system should be neutral so that decisions are made on their economic merits and be applied evenly so no party or individual receives an undue advantage. Lawmakers should periodically review all tax provisions to ensure the code is as efficient, fair, and neutral as possible. No section of the code should be off limits.

Despite a claim that "credit unions and and their employees already are saddled with substantial tax burdens," credit unions are not required to pay any entity-level taxes on their profits. While substantial tax burdens are a reality for many businesses and individuals, credit unions have a specific provision in the tax code that gives them an advantage over other financial services institutions that pay taxes through the corporate or individual income tax rate.

As a result, a concerning trend has occurred over the last several years where credit unions have purchased non-tax exempt institutions, including community banks. A September 2019 *Wall Street Journal* article "Credit Unions Go On Bank Buying Spree" finds over 30 examples of taxpaying banks being purchased by credit unions, with two-thirds of those deals occurring just within the last two years.

Some of these business deals should invite scrutiny from lawmakers on Capitol Hill.

In 2018, the second-largest credit union in Michigan bought a small community bank in Southwest Florida. With this purchase, Lake Michigan Credit Union now allows anyone in the state of Florida to become a member, despite their headquarters being 1,000 miles away.

Also in 2018, the Michigan-based Advia Credit Union became the first credit union in history to purchase three banks. Despite being based in Michigan, this credit union has purchased three community banks in two different states - Wisconsin and Illinois.

Again in 2018, the Evansville Teachers Federal Credit Union, a $1.7 billion credit union based in Indiana, bought a small bank in Louisville, Kentucky.

Credit unions are buying firms in unrelated industries too. Penfed Credit Union recently purchased an advertising agency called White64. Under terms of the agreement the ad agency will continue to serve existing clients and accept new business but these profits will flow directly to Penfed. This deal will now mean all earnings from White64 will no longer be subject to federal or state income taxes.

Permanently taking taxpaying business entities off treasuries' tax rolls and shrinking the tax base is a textbook example of poor tax policy. The purpose of the tax code is supposed to be neutral, rather than helping one particular business gain the upper-hand in the free market.

The budget and revenue implications of current policy are significant. If preserved in its entirety, the credit union tax exemption's revenue impact will be $22 billion over the next decade, according to Office of Management and Budget FY21 numbers. This revenue could be put towards more productive and more efficient purposes in the tax code through broad-based tax reform. About 75% of the tax advantage flows to the top 5% of credit unions—those with over $1 billion. However, if large credit unions continue the trend of purchasing taxpaying business and taking these entities off the tax rolls, it will increase the revenue cost of the provision.

Unrelated Business Income Tax

In addition to being exempt from federal and state income tax, federal credit unions are also not subject to the Unrelated Business Income Tax (UBIT). Under UBIT, a tax-exempt organization is not taxed on income that comes from an activity that is substantially related to the charitable, educational, or other purpose that is the basis for the organization's tax exemption. However, if a nonprofit, tax-exempt organization regularly carries on a trade or business that is not substantially related to its exempt purpose, except that it provides funds to carry out that purpose, the organization is subject to tax on its income from that unrelated trade or business. Simply put: if an organization derives revenues from activities unrelated to its tax-exempt purposes, the profit is taxed at for-profit business rates.

UBIT is an important component of the tax code to ensure tax-exempt organizations are abiding by the rules of the road and not merely using their exempt status to skirt taxes. For example, if NTU were to operate a coffee shop in downtown DC, or if a church were to open a high-end clothing store, the earnings from these activities would—and should—be subject to the UBIT, as the profits would be unrelated to their tax-exempt purpose.

However, since federal credit unions are considered instrumentalities of the federal government they can avoid taxation on profits unrelated to their core business functions. And since they are exempt, many large credit unions are taking advantage of their tax status by pushing the boundaries of their exemption.

As stated earlier, the profits of PenFed's advertising subsidiary, White64, are not subject to taxation. That means their earnings derived from work with the Washington Metro Area Transit Authority, Hilton Hotels, and other corporate clients are not taxed like other normal advertising agencies.

To that end, many credit unions have entered the commercial real estate business by either purchasing existing expansive office space or building their own buildings to lease out to other businesses. For example, PenFed bought an 11-story building, but will only use half the space, with the other half being leased to other companies. Apple Federal Credit Union plans to lease office space to other businesses, according to *Virginia Business*. The earnings from these outside ventures would not be subject to UBIT, despite commercial real estate having no bearing on a credit union's ability to serve their members.

Credit Unions Erode "Field of Membership" Requirements

With the enactment of the Federal Credit Union Act of 1934, Congress established membership rules for credit unions eligible to be considered a tax exempt institution. Credit unions are intended to serve individuals who share a "common bond," like working for the same employer, attending the same religious institution, or living in the same community. Today, many large credit unions have strayed from their limited mission and extended their services to nearly anyone.

For example, at the Virginia-based PenFed Credit Union, one of the largest credit unions in the United States, their website proclaims PenFed "has great rates for everyone!" On the website of the Evansville Teachers Federal Credit Union in Indiana, they say "Not a teacher? Not a problem! You don't have to be a teacher to join. There are thousands of ways to be eligible—making membership easier than ever before!"

Also, numerous credit unions have allowed all people within a state to be eligible. At Golden 1 Credit Union, anyone who lives or works in California (38 million people) are able to become a member. At the Lake Michigan Credit Union, anyone in Michigan's lower peninsula and even the entire state of Florida (21 million people) are able to join. It's a similar story at the Boeing Employees Credit Union, where anyone in Washington state (7.5 million people) is eligible to join.

By current federal statute, credit unions cannot serve the general public. People qualify for a credit union membership through their employer, organizational affiliations like churches or social groups, or a community-chartered credit union. If everyone in an entire state, or even multiple states, is eligible to join a credit union, then the eligibility requirements have violated the "general public" standard.

Beyond that, credit unions are also engaging in other questionable activities to bend the rules of membership. For example, many of the largest credit unions offer an option to donate to a charity operated by the credit union. For example, at Affinity Plus Federal Credit Union anyone can donate to their foundation and be eligible to join their credit union, no matter where one lives. At Alliant Credit Union in Illinois a donation of just $5 to their designated charity qualifies an individual for membership. To cover this donation, "Alliant will now pay you $5 for opening a savings account!" Either an $8 donation to the Financial Fitness Association or a $15 gift to the Computer History Museum allows anyone to join the country's sixth largest credit union, First Technology Federal Credit Union.

At Bethpage Federal Credit Union on Long Island, they tout that "membership is open to anyone with a $5 savings account." There are hundreds of examples of these kinds of policies that should raise the eyebrows of policymakers.

Lack of transparency for executive compensation

Federal credit unions enjoy several unique advantages that other private market actors are not entitled to. For instance, they are not required to file Form 990 to the Internal Revenue Service, as nearly every other non-profit and not-for-profit must do. Form 990 includes financial information about a non-profit organization including the salaries of its top executives. Because most information on Form 990 is available to the public, it helps provide transparency and accountability for organizations that enjoy tax-exempt status.

Larger federal credit unions—those with assets exceeding $1 billion—should be subject to Form 990 filing requirements, just like other tax-exempt entities. Reinstituting 990 filing for large credit unions won't come without compliance costs, which is why policymakers must take a thoughtful approach. While it is true that these institutions would already maintain much of the information that gets reported on Form 990, care should be taken to avoid inordinate increases in net recordkeeping burdens. For example, as an offset Congress and NCUA could work to streamline rules affecting how credit unions operate. Alternatively (and less ideally), Congress and the IRS could work to design a Form 990 "CU" that credit unions could use to expeditiously fulfill their reporting obligations with as much information they already have on hand as possible.

This is not a recommendation to be taken lightly. As NTU knows from direct experience, the scope and complexity of the 990 tax return has increased significantly over time for most nonprofit and not-for-

profit organizations (although small groups are at least permitted to file the simplified Form 990-EZ or 990-N). The information reporting requirements have become a burden in their own right, especially after the redesign of the form that took place for the 2009 tax year. But the best solution to this problem is not to provide filing exemptions for a lucky, connected few—rather, it is to simplify the process for all.

In any case, the current exemption from filing a Form 990 is highly unusual, primarily because Congressional intent has increasingly been motivated by a desire to encourage parity in transparency and accountability from organizations that don't file corporate profit tax returns. For many years large nonprofit or not-for-profit organizations such as universities and hospitals have been required to file Form 990 - even National Taxpayers Union must file such a form to report our financial information and compensation for top executives.

Additionally, Form 990 is the main enforcement mechanism to ensure compliance with Section 13602 of the Tax Cuts and Jobs Act, which requires a 21 percent excise tax on not-for-profit executive compensation above $1 million. It can be argued that since there is no way to determine the exact calculation of wages paid over $1 million, some credit union executives are avoiding tax they would otherwise owe. Tax policy experts can and do disagree on the merits of this tax, but making sure all non-profit entities operate under the same rules would increase accountability for Congress to periodically revisit the provision.

Conclusion

To be clear, NTU does not support increasing taxes on individuals or businesses, which is why any revenue that would be raised by either repealing the federal tax exemption or UBIT should be applied in a manner that would be revenue-neutral. In other words, this should be part of a larger process to broaden the tax base and lower rates.

The debate surrounding the credit union tax exemption and transparency is an important matter for all taxpayers as it is fundamentally about ensuring fair and equitable compliance with the tax code. With many credit unions growing significantly in both size and scope, it is time for Congress to reevaluate the tax exemption and other tax-related provisions governing credit unions.

About the Author

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