Do credit unions still warrant a tax exemption?

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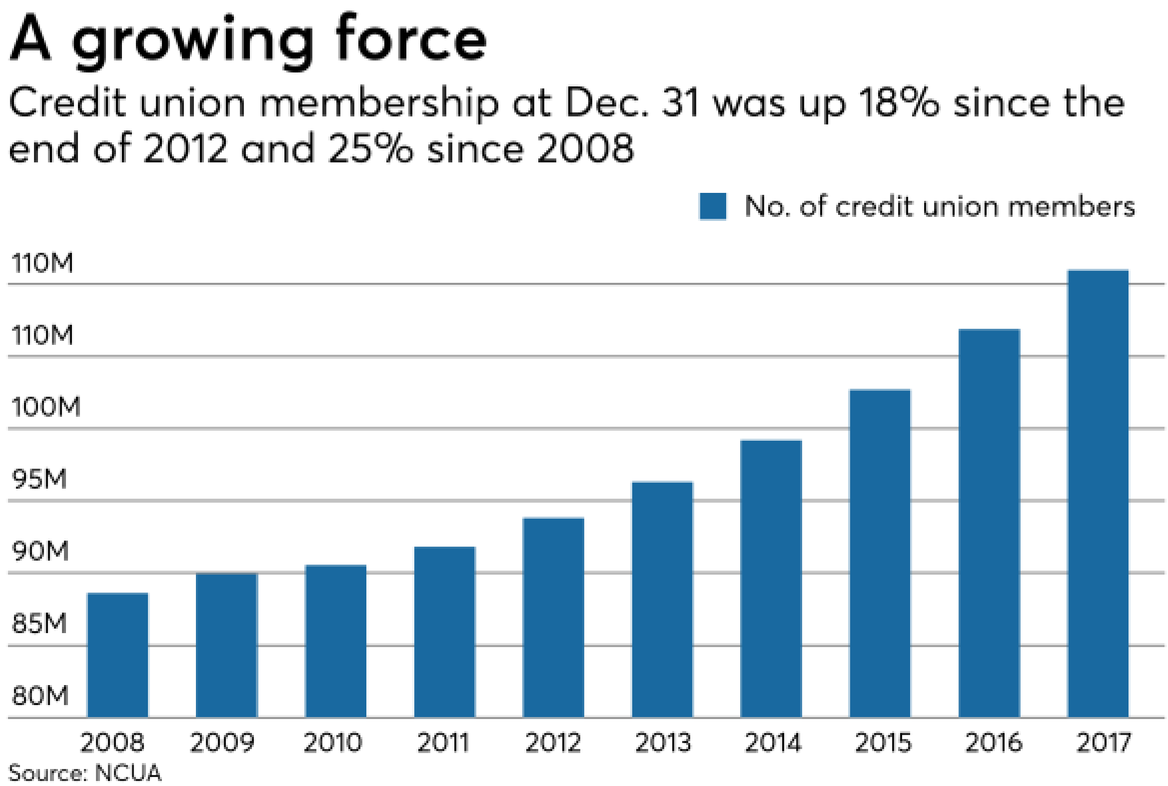
First in a series

When bankers question why credit unions remain exempt from paying state and federal taxes even as many increasingly operate more like banks, they have institutions like Jefferson Financial in Metarie, La., in mind.

Founded in January 1966 to serve employees of the local school system, Jefferson opened its first office on the second floor of a florist shop. Today it has more than 63,000 members and its field of membership includes 12 parishes and counties in Louisiana and Alabama, as well as more than 180 employee and affinity groups. Earnings for 2017 topped $8.6 million, up a whopping 147% from 2016.

Jefferson, with $890 million of assets, has also developed a reputation as a creative and aggressive commercial lender. In December, it led a consortium of credit unions that provided a $112 million syndicated loan to an Irvine, Calif.-based biofuels producer, Ryze Renewables, for construction of a refinery in Storey County, Nev.



As banking advocates see it, when a not-for-profit credit union has what they see as a rapidly expanding field of membership and leads a large loan syndication for which it likely competed against taxpaying banks, then it probably should not be exempt from paying taxes.

"When you look at the sheer size of the loan, it's shocking," said Keith Leggett, a retired economist at the American Bankers Association and a longtime credit union critic. "It's the largest credit union loan I've heard of. … It's an indication the credit union industry is going to be a more formidable competitor."

It’s hardly a new argument. For years, bankers have claimed that the decades-old tax exemption gives credit unions an unfair advantage over banks and have urged Congress to eliminate it — at least for larger credit unions that banks say have gone far beyond their original mission of serving households of modest means.

Credit unions have countered that, true to their mission, they pass the savings on to their members in the form of higher rates on deposits and lower rates on loans. They say, too, that their cooperative structure justifies their tax exemption and are quick to point out that banks enjoy their own competitive advantages that they rarely mention, such as the ability to easily raise capital.

Lawmakers — Republicans and Democrats alike — have largely sided with credit unions, taking the view that their tax exemption as a “third rail” that could endanger their political careers if they touched it.

But bankers may have finally found a champion in Sen. Orrin Hatch, a Utah Republican, who earlier this year stunned both the banking and credit union industries when he sent a letter to the National Credit Union Administration questioning whether credit unions of a certain size deserve to remain tax exempt.

Though the 84-year-old Hatch is not seeking re-election, his influence as chairman of the Senate Finance Committee is undeniable. His call to reflect “on the core mission of credit unions and their tax-exempt purpose” represents one of the most serious challenges to credit unions’ tax exemption since 1978, when President Jimmy Carter proposed its elimination.

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Bloomberg News

The letter has also re-energized a banking lobby that has grown used to lawmakers brushing aside its concerns. Not long after the letter was made public, 52 state banking trade groups sent a letter of their own to Hatch offering detailed examples of credit unions expanding far beyond their stated missions.

They targeted the $23.9 billion-asset Pentagon Federal in Tysons Corner, Va., founded to serve members of the military, which has significantly expanded its field of membership and recently spent $164 million building its new headquarters. (It also spent some $31 million on marketing last year, far more than most banks its size.)

They also pointed to the $11.5 billion-asset Golden 1 Credit Union in Sacramento, Calif., which paid $120 million over 20 years to secure the naming rights to the downtown arena where the National Basketball Association's Sacramento Kings play.

"Taxpayers should no longer subsidize these large, aggressive entities that are called not-for-profit, but don't act that way," the trade groups wrote to Hatch. "We urge you not to let the status quo stop your committee from ending this outdated tax exemption."

Representatives of Pentagon Federal and Golden 1 declined to comment.

Is this the start of something?

While bankers are cheering the Hatch letter, credit union supporters characterize it as much ado about nothing.

"It is worth noting that the one senator who wrote a letter about taxing credit unions didn't do it for 40 years in the Senate but waited until he announced he wasn't running for re-election," Dennis Dollar, a former chairman of the National Credit Union Administration, said in an email to American Banker. "His 'tax the credit unions because they are growing too much' letter has been met with virtually total silence from his congressional colleagues."

Dollar is right — no other members of Congress have backed Hatch and no hearings on repealing the tax exemption have been scheduled.

But Hatch's letter has rekindled debate in Washington and at the state level about whether the Depression-era exemption still makes sense two decades into the 21st century.

The same day Hatch released his letter, the Washington, D.C.-based Tax Foundation issued a report urging Congress to re-examine the tax exemption in light of the changes credit unions have undergone the past 40 years. It said that a tax on credit unions would add $14.4 billion to the Treasury over a five-year period ending in 2020.

Meanwhile, at the state level, Iowa's Senate approved a tax-reform bill in February that for the first time would impose on the state's 89 credit unions the same franchise tax that banks pay. The state's House has not yet taken up the bill, but the fact that it was passed by one chamber is seen as a major breakthrough for the state's banks.

Credit unions also suffered a significant setback in court. In March, Judge Dabney L. Friedrich at the U.S. District Court for the District of Columbia overturned parts of a regulation governing federal credit unions' fields of membership that the NCUA overhauled in 2016 to make it easier to add new members, injecting a new and unfamiliar degree of uncertainty for credit unions considering expansion.

Taken together, these developments have given bankers hope that a repeal of the exemption — while hardly imminent — is something they just may see in their lifetimes.

"I'm hopeful" that Congress will re-examine the tax exemption, said Chris Cole, executive vice president and senior regulatory counsel at the Independent Community Bankers of America, in a recent interview. "As you educate people out there, they're beginning to ask questions."

Abandoning the mission?

Back in December, the exemption looked all but set in stone after Congress had overhauled the tax code for the first time in three decades. Though lawmakers sorely needed to find revenue to help offset the roughly $1 trillion in tax cuts, they left the exemption untouched — a fact credit union advocates were quick to trumpet.

"Credit unions said loudly and repeatedly throughout this process that any change to the credit union tax status amounts to a direct tax increase on 110 million Americans, and Congress heard our message," Jim Nussle, the president and CEO of the Credit Union National Association, said in a statement Dec. 20, the same day President Trump signed the Tax Reform and Jobs Act.

Banks have long taken issue with credit unions' tax exemption, but it wasn't until Congress passed the Credit Union Membership Act of 1998 that they really began to see credit unions as a competitive threat.

That law allowed credit unions to accept multiple employer or affinity groups with no connection to one another within their fields of memberships, so long as they stuck to their "specified mission of meeting the credit and savings needs of consumers, especially persons of modest means."

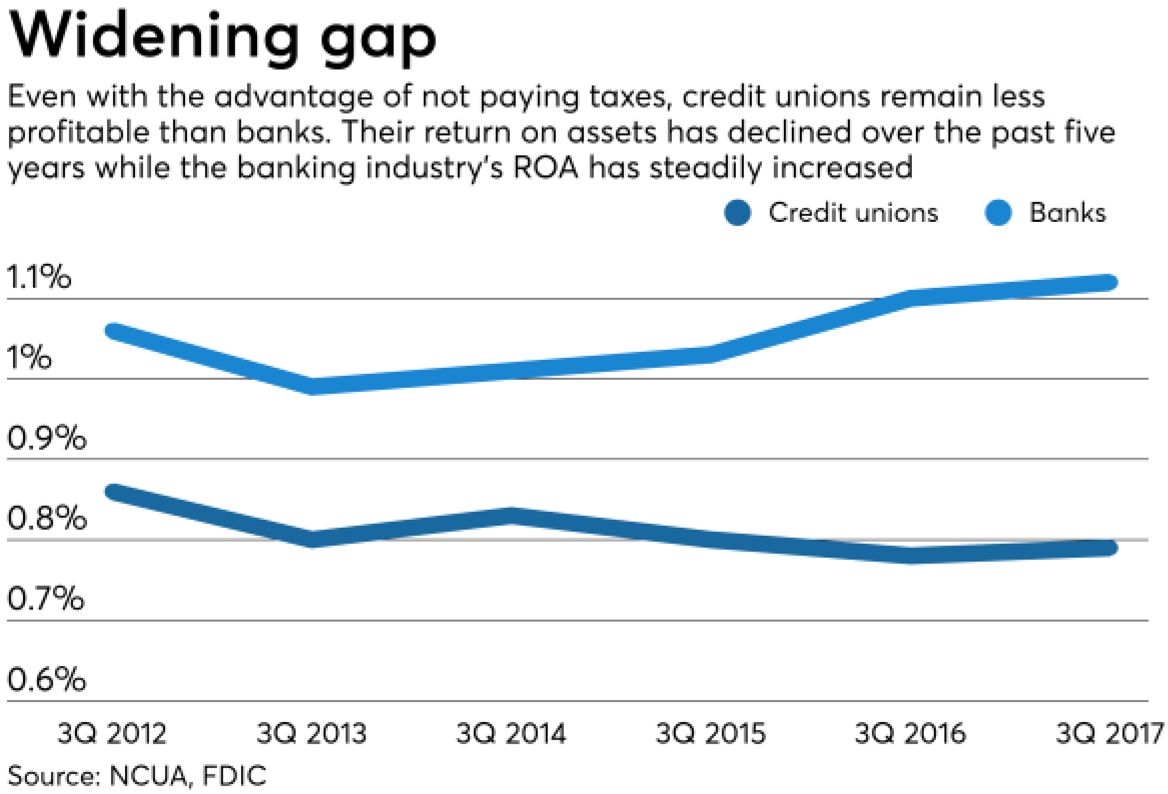
The language has not been amended since, and bank advocates claim that since then, credit unions have not only abandoned the restraints imposed by the common-bond requirement, but also their mission of serving low- to moderate-income households.

Robert DeYoung, a University of Kansas economist, says credit unions pass on as much as three-fourths of the benefit they accrue from not paying income taxes to their members in the form of higher rates on deposits and lower rates on loans.

But that help is going primarily to those in middle-income lending tracts, not the low-income consumers that critics say credit unions were originally chartered to help. Some of the debate turns on exactly what persons of “modest means” entails. Bankers argue that means low-income consumers, while the credit union industry sees it more broadly.

Citing statistics compiled by the Credit Union National Association and the Government Accountability Office, DeYoung found that credit union members are older, better-educated and have higher rates of employment and homeownership on average than bank customers. (The higher rate of employment may be at least partly explained because membership in credit unions is often predicated on whether and where a person works.)

Banks, to be sure, remain more profitable than credit unions, despite credit union members’ growing affluence. The banking industry’s return on assets in last year’s third quarter was 1.12%, compared with 0.79% for credit unions.



Even so, bankers remain ill-at-ease watching credit union membership continue to climb. It topped 111 million in 2017, up from 93.8 million in 2012. Over the past decade, credit unions' assets have more than doubled, to nearly $1.4 trillion.

Apart from seeking repeal of the tax exemption, the ABA and the ICBA have made challenging the NCUA's field-of-membership rule a major priority.

Leggett, who writes a blog pointing out examples of what he sees as credit union overreach, highlighted the case of the $148 million-asset New Cumberland Federal Credit Union in Pennsylvania.

The NCUA approved New Cumberland's application to for a field of membership encompassing five counties in central Pennsylvania earlier this year. Back in 2008, however, eight years before the NCUA overhauled its field-of-membership regulation, a federal judge rejected New Cumberland's application for an identical service area.

Ruling in a legal challenge brought by the ABA, Judge Yvette Kane commented that "to a casual observer familiar with central Pennsylvania, it would likely be a remarkable finding that … a geographical area of more than 3,000 square miles with a population over 1.1 million people and encompassing Harrisburg, Hershey, Carlisle, York, Lebanon, Gettysburg, and Shippensburg constituted a well-defined local community."

The NCUA might not be able to be as accommodating to credit unions seeking sweeping alterations to their memberships in the wake of Judge Friedrich's recent decision.

Friedrich invalidated one provision of the agency's field-of-membership rule that allowed credit unions to use combined statistical areas to delineate fields of membership, as well as a second that permitted rural districts with as many as 1 million people, even if such districts stretched across state boundaries.

Friedrich upheld two other provisions of the field of membership that had been challenged by the ABA, but her 39-page decision provided plenty of fodder for bankers seeking to zero in on the industry's tax exemption.

Regarding the rural district provision, for instance, Friedrich concluded that the NCUA went far beyond its legal discretion. "Because the rule automatically qualifies areas larger than states as rural districts even though the term commonly referred to areas smaller than a county, the NCUA's definitional decision is unreasonable and manifestly contrary to the statute," she wrote.

Credit unions are even facing a backlash north of the border. Organized on cooperative lines similar to U.S. credit unions, the Canadian industry lost its federal tax-advantaged status in 2013. Now, Manitoba's provincial government has proposed eliminating a special deduction that credit unions there have enjoyed for decades. The proposed budget that Premier Brian Pallister's introduced March 12 would phase out the tax benefit beginning next year, potentially generating $15 million in revenue over four years.

According to local press accounts, Manitoba's finance minister, Cameron Friesen, claimed credit unions and banks now compete head to head, making rendering the special deduction superfluous.

"We don't believe [credit unions] need an additional deduction available only to them," Friesen told the Winnipeg Free Press.

'The difference is our structure'

Credit union advocates are broadly dismissive of bankers' arguments. They claim the industry's cooperative structure, where institutions are owned by their members, all of whom have an equal say in their management, make credit unions fundamentally different from banks regardless of any other similarities.

"We know what the bankers are going to say. They're going to say we're just like them. If it looks like a duck and quacks like a duck, blah, blah, blah," said Geoff Bacino, a credit union consultant and former member of the NCUA board. "We're going to respond by talking about our structure. The difference is in our [democratic] structure."

Credit unions often can't pay their directors (and when they can, it's usually a small stipend) and they cannot issue stock, Bacino noted.

"Everything is not just about the bottom line, it's for the members," he said.

Comments like Bacino's still carry weight in Congress. A number of lawmakers spoke in support of the tax exemption last month at the Credit Union National Association's annual governmental affairs conference.

Rep. Linda Sanchez, a California Democrat and a member of the House Ways and Means Committee, said that while an overhaul of the tax code is overdue, she wants a system "that provides economic certainty for working families.

"Preserving the current tax-exempt status for credit unions is a key part to providing that certainty," she said.

Jim Blaine, who served as CEO of the $37.3 billion-asset State Employees Credit Union in Raleigh, N.C., for 37 years, said agitation over the exemption works better as trade-group politics than a real public policy debate.

"The best way to unify a group is to have somebody to hate," Blaine said in an interview. "We know the banking industry will never give it up because it sounds grossly unfair. If I'm taxed and you're not, that must be bad. … But I think those who have been around a long time understand that the tax-exempt status of credit unions is not a decisive factor in the competitive market."

Still, bankers frame the issue as one of basic fairness.

“Most hardworking Americans don’t understand that these giant credit unions are not paying income taxes,” said Dave D. Nelson, the president and CEO at $2.1 billion-asset West Bancorp in West Des Moines, Iowa. “Then, when they finally do realize that they’re subsidizing them, they get angry. They wonder why we don’t get that changed.”

‘Elephant in the room’

For his part, Bacino said he does not think that banks’ current offensive would go any further than any of the previous anti-exemption blitzes bankers have mounted — but it shouldn’t be dismissed out of hand.

“I do think credit unions need to be aware of the fact that sometimes these things happen quickly; they sometimes happen in a vacuum,” he said. “I think it’s something we should at least acknowledge while hoping it never happens. It’s a little like nuclear war.”

Bacino plans to host an “Elephant in the Room” conference in December to give credit union supporters the opportunity to meet and discuss the taxation issue.

It’s not just bankers questioning the validity if the tax exemption. A number of commenters with no financial industry ties and no dog in the fight have also wondered why credit unions are treated differently.

Yael Ossowski, the deputy director at the Consumer Choice Center in Washington, D.C., said he began to pay more attention to credit union taxation after being struck by the presence of several large credit unions in his home state of North Carolina.

“The huge footprint with a lot of these credit unions sparked my curiosity,” Ossowski said. “I wanted to know what the difference between banks and credit unions is and I discovered there isn’t much anymore.”

He made his views public in September, publishing an op-ed in the Charlotte Observer urging elimination of the tax exemption.

In a similar way, Tax Foundation analyst Erica York, who wrote the Jan. 30 report calling for a review of the exemption, said her interest in the subject was sparked by the "huge footprints" at a number of large credit unions.

York acknowledged the Tax Foundation has long questioned the validity of the exemption, but added that she approached the topic with an open mind, having joined the group in November. She examined an IRS report from 1979 that provided some explanation for why credit unions were tax-exempt and found that some of the key reasons — catering to the unbanked, limiting their customer bases — no longer apply.

"There isn't much difference anymore" between credit unions and banks, she concluded.

Like Ossowski, York was quick to praise the focus on consumer lending by most credit unions, as well as their cooperative structure. She sounded less sure about their tax treatment, however.

"It's an interesting and good model, but the question is, because they have such a model should credit unions pay less taxes?" York asked.

Even one credit union executive has questioned whether the tax exemption still makes sense in certain cases.

In an op-ed in Credit Union Journal earlier this year, Robert Taylor, president and chief executive of ISU Credit Union in Pocatello, Idaho, said some larger credit unions had lost their way and should be treated like banks.

"I agree with Senator Hatch that many larger credit unions operate in the same manner as taxable banks, and I believe it's time for them to convert to bank charters and be taxed like the 'big boys,' because the credit union movement doesn't need them," he wrote. "The credit union trade associations who want to preserve the tax exemption for all of us must stop trotting out smaller CUs before members of Congress to "tell our story" — which is not the story of bank-like credit unions — when it's clearly a disadvantage for smaller credit unions to support a tax exemption for banklike credit unions.

But Dollar, the former NCUA chairman, said that the size of credit unions really should have no bearing on whether they remain tax-exempt.

Credit unions may indeed be “bigger than they used to be, offer more products than they used to offer and serve a broader base of people than they used to serve,” but they still retain their democratic, cooperative structure, according to Dollar.

’It would be like the people at Nabisco saying that the Girl Scouts should be taxed like them because they are bigger than they used to be, sell more flavors than they used to sell and offer their cookies to more people than before,’ said former NCUA Chairman Dennis Dollar.

That structure, more than anything else, justifies their tax exemption, said Dollar, now an industry consultant.

“In almost every industry in America there is a for-profit sector and a not-for-profit structure,” Dollar argued. “One pays corporate income tax and the other doesn’t. It is structurally based, not product- or size-based. There are for-profit hospitals like HCA and Tenet, while there are not-for-profit hospitals like Ascension, Trinity and Adventist. All have emergency rooms and CAT-scans. All serve millions of people. One is subject to corporate taxation and the other is not.

“If you took the bankers’ argument … to its absurd extreme, it would be like the people at Nabisco saying that the Girl Scouts should be taxed like them because they are bigger than they used to be, sell more flavors than they used to sell and offer their cookies to more people than before,” Dollar added.

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For Dollar, the $14 billion or so that Congress could raise over the next five years by taxing credit unions pales in comparison to the $156 billion he says credit unions saved consumers in the past decade.

“With over 110 million members, it is a pretty tough political sell for the bankers to get Congress to potentially anger so many voters for such a small tax revenue return — just to make a handful of local bankers happy,” Dollar wrote. “As we say down South, the juice is just not worth the squeeze politically for a member of Congress seeking re-election.”

Tomorrow: How banks and credit unions came to be adversaries.
Thursday: What the financial services landscape would look like if the tax exemption were eliminated.

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3 Comments

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