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In this issue

- **Nonprofits versus the taxman**
- **The experts weigh in**
- **...and good luck with IRS guidance!**

Nonprofits gird for tough new tax rules

We're executive recruiters, not lawyers, so you generally won't catch us opining on important lawyerly stuff like detinue, replevin, trover; or even usufruct (especially usufruct). We'll leave all that to the learned JDs.

But, in our daily conversations with investment heads in the nonprofit world, we've been getting an earful about the latest Congressional tax edicts, which will make hiring senior executives much more expensive.

The Bare Bones

The 2017 Tax Reform Act fills 500 pages of small print. It has some good points and bad points apart from lowering individual and corporate tax rates, which got all the public attention.

Under "good," it lowers the excise tax on beer to $16 per barrel. No problem there.

But, under "not so good" are two sections pertinent to the heads of college endowments, and to nonprofit organizations in general. Those include charitable grant-makers, symphonies, museums, hospitals, and many other charitable entities.

The first (Code Section 4968) imposes a 1.4% excise tax on the net investment income of certain private colleges and universities. We had our say about this elsewhere.

The Yale Tax, as it might be called, will raise a risible $1.8 billion over ten years.

Calling this a drop in the bucket would be an insult to drops and buckets. It's $180 million annually in a $3.8 trillion U.S. budget and strikes us as a political gesture which raises virtually no money and accomplishes no practical purpose, even for people justifiably aggrieved about college costs.

The second section (Code Section 4960) is what nonprofits generally – not just colleges – are alarmed about as it begins to kick in this year, because it will raise the cost of hiring senior employees.

We recruit nonprofit investment heads and advise boards on compensation and performance. So, any tax that makes hiring chief investment officers and other executives more expensive and complicated gets our attention.

More broadly, it makes it harder and more expensive for these charities to carry out their missions, which should concern everyone.

Section 4960 imposes an excise tax on "excess" executive compensation at tax-exempt organizations.

Congress has decreed that any non-profit employee compensation exceeding $1 million is "excess."

The tax will amount to 21 percent of the so-called "excess" compensation, and it will pertain only to the five highest-paid employees.

Chief investment officers – and CEOs, and football coaches – will be relieved to know that the tax will be levied on the employers, not on the employees.

But, it will obviously have a knock-on effect on how much they can afford to pay new hires, or how big a raise they can offer talented incumbents to help keep them aboard.

Some wag has referred to this as the Nick Saban Tax, in honor of the redoubtable Alabama football coach. Coach Saban is said to be the highest-paid college coach in the country at $8.3 million in 2018.

Coach Saban is well known, and so is his compensation, at least among Southern Conference fans. But there are more obscure execs also in the cross-hairs, e.g. Anthony Tersigni, CEO of the huge Ascension Health system in St. Louis, who earns even more. He takes home $17.5 million, and a few other nonprofit healthcare execs were also up in the 8-digit range. (The Act explicitly excludes practicing physicians, who are often the highest-paid people in these organizations.)

It looks like Ascension will be on the hook for at least an extra $3.5 million annually just to keep Mr. Tersigni.

We estimate that the celebrated Yale chief investment officer David Swensen is currently making about $6 million. And we think the average CIO among big endowments now makes about $2 million.

All three of these gentlemen are among the very best in their respective professions, and they are arguably worth every penny of their – admittedly handsome – salaries.

Let's do the math for Mr. Saban: 8.3 minus 1.0, times 0.21, equals 1.5. So, Alabama will have to budget for at least an additional $1.5 million yearly. That's a budget item they hadn't even thought of just a year ago.

The Wall Street Journal has counted 2,700 nonprofit employees (not just at colleges) who were paid over $1 million in 2014.

Total take to the feds from the Saban tax might be $9.2 billion over 10 years (per the Joint Tax Committee). That's more than the $1.8 billion for the Yale tax. But even the total $11 billion ($1.1 billion per year) is still trivial in the context of federal budgeting.

That revenue estimate implies that the average employee in that cohort makes around $2.5 million. Or, about $1.5 million of "excess" comp per employee, as Congress looks at things.

Who's the boss?

Negotiating for a salary (or anything else) in the free market is, as the Nobel-winning economist F. A. Hayek taught, a discovery process. No one knows what someone's work is worth until the market figures it out.

In our view, the boards and donors of charities are fully capable of deciding what portion of a nonprofit's budget should be used to hire the best executive talent they can afford. We see no reason why government officials who know nothing about managing those organizations should load the budgetary dice. And, if donors take exception to how a charity is being run, they're in the best position to influence policy by simply withholding their support, or by directing it elsewhere.

Nonprofits don't have taxable profits, so it doesn't work to limit deductions for salary expenses as Congress has already done for private businesses. Instead, an excise tax must be resorted to which, in this case equals the current 21 percent statutory corporate income tax rate. (In case you were wondering where that specific rate came from.)

The excise tax tries to impose the same degree of discouragement on an 'allegedly' too-generous tax-exempt employer using a slightly different mechanism.

And, voila! a historically tax-exempt charity is suddenly no longer tax-exempt!

None of the language in the tax code has actually been turned into IRS regulations yet. Until some of issues gel, nonprofits are going to be grappling with some uncertainties. Perhaps for years.

In this highly condensed look at a complex tax issue we've omitted important details. Targeted organizations should consult real experts.

We may not be lawyers or accountants, but we are citizens; and in that capacity everyone gets a say.

As we adduced above, the revenue raised by Sections 4960 is paltry. So, what's the point of quietly inserting them into a giant tax bill with minimal discussion or publicity? There could be many reasons. For one thing, it puts a federal foot in the door. If endowments that are "too big," or nonprofit executives who are paid "too much" can be taxed a little, it will be a lot easier to tax them more in future, the precedent now being set.

It also motivates targeted organizations to come hat-in-hand to Congress, hoping to cushion future blows. No doubt this is gratifying to Congress, but it just further distracts and impedes nonprofit leaders from accomplishing their historic missions.

The experts weigh in

1. *Michael Conover, JD (BDO)*
Excise Tax 'Bite' on Nonprofit Compensation

2. *McDermott Will and Emery*
Top Takeaways for Tax-exempts from IRS Guidance on Executive Compensation

3. *Ruthann J. Woll, CPA*
Nonprofits: Lessen the Impact of New Executive Compensation Excise Tax with These 3 Tactics

4. *Louis Vlahous, CPA*
It's a Business . . . No, It's a Charity . . . Wait – It's a Charity That Is Treated Like a Business?

5. *Nixon Peabody LLC*
Legislation adds significant new tax on exempt organizations' executive compensation

6. *Economic Research Institute*
Tax Reform Hits Compensation of Nonprofit Executives in 2018

7. *NACUBO*
IRS Issues Interim Guidance on Executive Compensation Excise Tax

8. *Inside Higher Education*
Tax Law's Effects on Colleges Unfolding

9. *IRS*
Interim guidance under Section 4960

The Skorina Letter

Each issue explores how the world's most accomplished asset managers think and invest. Original content includes profiles and interviews with industry veterans and research on compensation and investment performance.

Our insights and commentary come from our clients - board members, CEOs, chief investment officers - and the global investment community within which we work as executive search professionals.

Institutional investors operate at the crossroads of capital, talent, and ideas, shepherding over seventy trillion dollars in global assets. It's a constantly evolving spectacle and The Skorina Letter gives readers a ringside seat.

Prior issues can be found in "archives" on our website.

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