The Skorina Letter

News, Interviews, Research for Institutional and Family Office Investors

● Retained Executive Search ●

Our **clients**: board members, families, and institutional asset managers
Our **services**: recruit chief investment officers - advise on compensation & performance

http://www.charlesskorina.com/ skorina@charlesskorina.com
Office: 520-529-5677

In this issue

Nonprofits gird for tough new tax rules

We aren't lawyers, so you won't catch us opining on important lawyerly stuff like detinue, replevin, trover; or even desuetude (especially desuetude). We'll leave all that to the learned barristers.

But, in our daily conversations with investment heads in the nonprofit investment 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, and it has some good points and bad points.

On the micro-level, under "good," it lowers the excise tax on beer to $16 per barrel. It also changes the IRS definition of "mead" (which we have urged for years). No problem there.

And, at the macro level, also under "good," it seems to have worked pretty much as advertised.

The Act kicked in on January 1, 2018. Over the rest of FY2018, GDP and personal income rose nicely, at least partly due to the stimulus of tax cuts.

What's more, even with significant cuts in the rates for both individual and corporate filers, business expansion caused total U.S. tax collections to rise slightly year-over-year, by 0.05 percent. Win-win.

Under "not so good," are two sections pertinent to endowment managers and their bosses.

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 when and if the lawyers figure out how to apply it. 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.

The second section (Code Section 4960) motivates today's sermon.

We recruit investment heads and advise boards on compensation and performance, so any tax that makes hiring CIOs more expensive gets our attention.

This recent law imposes an excise tax on "excess" executive compensation at tax-exempt organizations, including 501c3s. The latter include virtually all private colleges and (probably) many public ones.

Congress seems to have intended to include state universities in the sticky embrace of 4960, not just their parallel foundations; but they may have to fix the language in the bill they actually passed.

The IRS has decreed that any non-profit compensation exceeding $1 million is "excess." Apparently, because it's a nice, round number; and also because congresspersons make only $174K per year.

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

Chief investment officers – and presidents, and football coaches – will be relieved to know that the tax will be levied on their 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 high-performing incumbents.

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

They picked Mr. Saban because he's well-known, and so is his comp. But the more obscure nonprofit Ascension Health CEO Anthony Tersigni, earns $17.5 million, and a few other nonprofit healthcare execs were also up in the 8-digit range.

In our latest report on endowment CIO compensation, we estimate that Mr. Swensen at Yale is currently making about $6 million. And we think the average CIO among big endowments now makes about $2 million.

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. 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. But the typical excise tax will be far less than Mr. Saban's.

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 an absurdly minuscule number in the context of federal budgeting.

To get \$0.92 billion in tax per year for 2,700 people 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?

It would clearly be pointless to arrange for competition, if we were certain beforehand who would do the best. I propose to consider competition as a procedure for the discovery of such facts as, without resort to it, would not be known to anyone."

F.A. Hayek – Competition as a discovery procedure - 1968

Negotiating for a salary (or anything else) in the free market is (as Professor Hayek taught) a discovery process. No one in Heaven or on Earth knows what someone's work is worth until the market figures it out.

In our view, the boards, owners, and donors are fully capable of deciding what portion of the budget should be used to hire the best-possible C-suite women and men.

Congress, however, in this tax law offers an alternative to competition. Nonprofits don't have taxable profits, so it doesn't work to limit deductions for salary expenses. Instead, an excise tax must be resorted to which, in this case equals the current 21 percent statutory corporate income tax rate.

The excise tax imposes the same degree of discouragement on nonprofit employers as limits on deductions do in the for-profit world using a slightly different mechanism.

And, for all intents and purposes, historically tax-exempt organizations are now not tax-exempt.

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

In our highly condensed version above we've omitted many details about 4960. Please consult the people below for much more information.

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.

Charles Skorina & Company
Retained Executive Search
Chief Investment Officers ● Institutional Asset Managers
6080 N. Sabino Shadow Lane
Tucson, AZ 85750
520-529-5677
skorina@charlesskorina.com
www.charlesskorina.com

THE SKORINA LETTER ***Sign-up***
News & Research for Investment Leaders

Prior:
JPMorganChase - Credit and risk management
Ernst & Young - Systems and process consulting
US Army - Russian Linguist, Japan
University of Chicago, MBA, Finance
Michigan State University and
Middlebury Institute of International Studies at Monterey
Culver Academies