New Excise Tax: How Will It Impact Nonprofits?
An expert clears away the confusion over this new tax.

We connected with Spencer Walters, an attorney at the Washington, D.C. tax-law firm, Ivins, Phillips & Barker, Chtd. (Ipbtax.com) to discuss the new 21% excise tax that is impacting nonprofits. This new tax presents some unexpected consequences for tax-exempt entities.

What is the IRS Code Section 4960 excise tax?
This new excise tax applies to nonprofit entities and related organizations starting for 2018. It’s a 21% tax that kicks in on amounts paid to certain employees beyond $1,000,000 or beyond a severance multiple if the employee is paid out upon involuntary termination of employment.

Is this the “college-football-coach tax”?
Yes, exactly.

So, if an organization doesn’t have a football coach, can the tax still apply?
It can still apply! The tax will catch university pay to executive leadership, as well as executives at other tax-exempt entities, including hospital administrators. A nonprofit organization could be affected if it is related to an entity (including a for-profit corporation) that employs individuals who are – or ever were – employees of the nonprofit.

In fact, as it turns out, the tax may not apply to some of the highest paid collegiate coaches because of a drafting accident – many public universities are shielded from this tax because they are arms of a state government.

Who pays the tax?
The new tax falls on employers, not on the employees. Nonprofit organizations and their related organizations are responsible for calculating and paying the tax.

Who are the employees that trigger the tax?
Under the new law, each year, the tax-exempt entity must identify its top-five highest-paid employees. These individuals become “covered employees” and remain as such forever. Under the proposed IRS rules, pay from any related organization counts toward whether the employee is in the top five.
When do these employees trigger the tax?

This ever-growing pool of “covered employees” can trigger the tax in either of the following conditions:

• The covered employee has pay that exceeds $1,000,000 in a year including any bonus earned (even if paid in a later year) and any deferred compensation that becomes vested.

• The covered employee involuntarily terminates employment and receives a severance payment of more than three times the individual’s average pay over the three years before termination.

Broader Reach than Expected

What is the most surprising aspect of the new tax for nonprofits?

The most surprising part of the IRS rules is that the tax could apply even if no employee of the nonprofit organization is paid $1,000,000 or has pay in excess of the severance threshold.

One way this can happen is because the definition of pay is different from what we ordinarily call pay. It’s not taxable wages reported to the employee on a W-2. Nor is it pay that the organization may already report on a Form 990 filing.

Another way the tax could unexpectedly apply is because of the “related entity” rule. If a nonprofit has a related entity, then all pay from every related entity counts. It counts for purposes of whether the employee is a top-five highest-paid employee. And it counts for purposes of whether the employee exceeds $1,000,000 in pay or hits the severance threshold. This means an employee could receive little or no pay from a nonprofit organization but a related company or entity would still owe the excise tax. For example, a company CEO is paid $2,200,000 per year and also is an employee of the company foundation without any additional pay. The company pays a 21% tax on $1,200,000.

More problematic, because of the “Once a Covered Employee, Always a Covered Employee Rule,” pay from a related entity could result in a tax even after the employee has stopped providing services to the tax-exempt entity.

How can a related entity avoid this tax?

Being a top-five highest-paid employee of a nonprofit organization forever sticks with employees for any pay they receive from a related entity of the nonprofit. It appears that the only way to end this status is to either (1) sever the nonprofit organization from its related organization or (2) dissolve the nonprofit organization.

Who counts as a related entity of a nonprofit organization?

A related entity includes any entity that is controlled by or controls the nonprofit organization. Commonly a company foundation is related to the company that establishes it because the company names its directors.

A related entity also includes an entity that is controlled by any person that controls the nonprofit organization. For example, if an entrepreneur establishes a family foundation, the foundation may be related to the entrepreneur’s businesses.

Finally, a nonprofit organization is considered related to any “supported organization” or “supporting organization” with respect to the nonprofit organization.

Potential Impacts & What To Do

What effect could this new tax have on nonprofit organizations?

A relatively small number of nonprofit organizations pay employees enough that they would be directly affected. However, we fear that this change could reduce involvement in philanthropic organizations by highly-compensated executives and businesspeople. It could discourage companies and entrepreneurs from starting charitable foundations and even cause some companies to close their charitable foundations.

Put two companies side by side, each paying their founder and CEO $2.5 million per year: The first establishes a foundation and its CEO plays an active role running its charitable efforts, although she draws no additional salary from the foundation, while the second forgoes charitable contributions to pay dividends to shareholders. Because of the first company’s philanthropic efforts, the company is hit with a $315,000 extra tax bill (21% of $1,500,000). You can see why fewer companies might form new charitable foundations.

It’s more difficult to predict the indirect effect this new tax could have. Often, private and family foundations are the initial or primary funders of smaller nonprofit organizations. Of course, even if the tax causes foundations to change their practices (or causes companies not to have foundations), companies and individuals wouldn’t necessarily stop making charitable contributions. They could continue making direct charitable contributions, although there isn’t
Another fear is that corporate giving may be less stable and more subject to the whims of company budgets.

What was Congress thinking with imposing this tax so broadly?

There’s a well-intentioned rationale behind the tax. The thinking was that foundations and charitable organizations receive significant tax benefits. For example, when a company funds a foundation, it can receive an immediate tax deduction and there are no – or relatively small – taxes on the foundation’s ongoing operations (although there are a lot of requirements to make sure the foundation actually provides charitable benefits). The rationale was simple: These tax benefits shouldn’t be used to subsidize high pay.

The problem is that the new tax applies even when these subsidized tax benefits aren’t being used to pay high salaries – even when a private company is paying the entire amount to the employee.

Can a tax advisor plan around the new tax?

Yes, there are ways to plan around the tax, and nonprofits and related organizations should consult their advisors to determine how best to do so. As with many well-intentioned tax provisions, one big concern is that this tax becomes a trap for the unwary.

The potential “fixes” will need to be specific to each nonprofit organization. For example, company foundations may want to prevent their employees who are, or someday may be, high-paid from being involved in the charity.

Another approach is to make sure that any individuals involved in the foundation don’t become “employees” of the foundation under IRS rules. The IRS typically is aggressive in arguing employee status. For example, the IRS’s presumption is that an “officer” is a de facto employee, so a safe approach may be to avoid having company employees be officers.

Can the IRS fix these problems?

The IRS is stuck with the law as Congress wrote it. But it has flexibility to offer relief.

We think the IRS could help by making sure that the tax applies only to amounts that are actually paid by the nonprofit organization. For example, company foundations may want to prevent their employees who are, or someday may be, high-paid from being involved in the charity.

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We think the IRS could help by making sure that the tax applies only to amounts that are actually paid by the nonprofit organization. It could do this in part by limiting who counts as an “employee” of a nonprofit organization for purposes of the new tax.

We are hopeful that the IRS won’t interpret the tax too broadly and will think of the unexpected consequences of the tax when they write the final rules.

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