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The Endowment Tax: Thoughts and Considerations for Investors

INVESTMENT BRIEF | APRIL 2025

The Endowment Tax was introduced during the first Trump administration as part of the 2017 Tax Cuts and Jobs Act (TCJA). It was set at an initial tax rate of 1.4% levied on the Net Investment Income (NII) of private colleges and universities with enrollments of at least 500 students and endowed assets of $500,000 per student or more. Multiple bills have been introduced in the House of Representatives during the current legislative session. These bills seek to increase the endowment tax rate and lower the endowed assets per student threshold, increasing both its magnitude and scope.

In this brief, we examine some potential solutions available to institutions seeking to minimize the potential impact of the tax. First, we think it's beneficial to review the definition of Net Investment Income, the amount on which the tax is applied. Second, we'll discuss strategies and considerations for endowment managers that focus on the two components that add to NII; we'll not touch on allowable deductions, an area better left for endowment staff, administrators, and advisors. Finally, it must be stated that we're not tax advisors. Our intent is to highlight various strategies and approaches that endowments may consider in seeking to better prepare themselves should a probable change to the tax code be enacted.

Defining net investment income

Net investment income = Gross investment income + Realized capital gains − Allowable deductions

Gross investment income:
Includes interest, dividends, payments on security loans, and royalties, but excludes UBTI and interest from tax-exempt state and local bonds.

Realized capital gains:
Sale price of a security, minus cost basis of the security.

Allowable deductions:
Expenses paid or incurred for the production, collection of Gross Investment Income, or the management, conservation or maintenance of property held for production of that income.

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Internal Revenue Service guidance

Upon passage of the Tax Cuts and Jobs Act in 2017, clarity was requested from the Internal Revenue Service (IRS) related to several provisions of the Endowment Tax, to which their official guidance was issued with the final regulations on October 14, 2020. While there are too many regulations to summarize in this brief, here are a few key takeaways as it relates to our endowment tax discussion:

1. EXCLUSIONS TO GROSS INVESTMENT INCOME

- Interest income from state and local bonds.
- Interest income from student loans made by the institution or a related organization to a student enrolled and attending that institution.
- Rental income from the provision of housing to students attending that institution and from housing for faculty and staff if that housing is provided contingent on their roles at the institution.
- Royalty income from patents, copyrights and other intellectual property to the extent those assets resulted from the work of faculty or students in their capacity as such at the institution.

2. ALLOWABLE DEDUCTIONS

- All ordinary and necessary expenses paid or incurred for the production or collection of gross investment income, or for the management, conservation, or maintenance of property held for the production of such income. This includes compensation for officers, salaries and wages of employees, outside professional fees, interest, and rent and taxes on property used in the institution's operations directly tied to the generation of gross investment income.

3. TREATMENT OF CAPITAL LOSSES

- Capital loss carryovers are allowed and may be deducted from capital gains in a future year. Capital losses more than capital gains cannot offset other components of Gross Investment Income.

Summary of proposed legislation

As of March 21, 2025, three bills have been introduced to the House of Representatives and referred to the House Ways and Means Committee. None of these bills have been debated at the committee level yet. Diagram 1 shows a summary of each bill, in the order of when they were introduced.

ESTIMATING THE FINANCIAL IMPACT UNDER THE CURRENT TAX CODE

We think it's instructive to estimate the potential financial impact of a proposed increase in the endowment tax to not only underscore the magnitude of such a change, but also to aid in framing a discussion of potential strategies endowment managers may consider in the wake of an adjustment.

DIAGRAM 1: PROPOSED BILLS ON ENDOWMENT TAX

	HIGHER EDUCATION ACCOUNTABILITY ACT	ENDOWMENT TAX FAIRNESS ACT	ENDOWMENT ACCOUNTABILITY ACT
House bill	H.R.9331	H.R.446	H.R.1128
Date introduced	August 9, 2024	January 15, 2025	February 7, 2025
Tax rate	10%	21%	10%
Asset threshold per student	$250k	$500k	$200k
Effective date	January 1, 2025	Year Following Passage	Year Following Passage
Other	Increases tax rate to 20% on institutions raising tuition by more than inflation	-	-

Source: Congress.gov, 3/21/2025.

Following our discussions with more than 20 'in-scope' endowments, the current 1.4% tax has resulted in a 2 to 12 basis point annual headwind, which implies a total NII as a percentage of assets of 1.4% to 8.6% *(2 bps/1.4% = 1.4%; 12 bps/1.4% = 8.6%)*. This is obviously a large range and several factors, including market environment, asset allocation, manager contributions distributions, and overall liquidity profile, can influence the exact percentage meaningfully. For simplicity, we will assume a midpoint of that range, or 5%, as a reasonable estimate of the annual NII as percentage of total assets for in-scope endowments.

With interest, dividends, and capital gains as the components to NII, it should be unsurprising that, on average, capital gains are its largest contributing factor. While interest income may comprise most of the long-term total return on fixed income investments, endowments typically maintain larger allocations to public and private equity. Dividends do contribute meaningfully to long-term expected equity returns, but the overall equity risk premium has historically been driven by capital appreciation. Thus, investors should expect capital gains to be the largest source of NII in a typical year.

IT'S ALL ABOUT REALIZED CAPITAL GAINS

Any strategies endowments may consider to help mitigate the burden of current and future tax should center on the management of realized capital gains. In the balance of this brief, we offer thoughts and considerations on how endowment managers can potentially position and manage their assets to enhance the clarity and control of (mainly) capital gains realization.

It's worth pointing out the obvious: there is neither a silver bullet nor a free lunch regarding the avoidance of realized capital gains taxes. As markets tend to rise over time, when an investment is eventually sold, a capital gain will be realized and barring a change in the tax code, subsequently taxed. Thus, most strategies and tactics endowments may employ will be centered on tax deferral and not tax avoidance. And some of these strategies may run counter to existing investment processes or philosophy.

Now, let's go back to the broad estimate of annual NII of 5%. At the current tax rate of 1.4%, this equates to an annual tax burden of 7 bps at the fund level, which can be considered a nuisance for most. With tax increase proposals ranging from 10% to 21%, the burden would jump to between 50 bps and 105 bps.

Given large allocations to illiquid, private assets, a clear challenge for many endowments is how to influence and manage the realization of capital gains using strategies that can only be applied to their marketable investments. One of the clear tradeoffs associated with private investments is the loss of direct gain realization for higher expected long-term returns.

Possible tactics and strategies for endowments

SUMMARY

- Accelerate the **realization of capital gains** and seek to reset investments to a higher cost basis prior to the tax change taking effect.
- Early in the year, realize as many capital gains as necessary, ideally in conjunction with portfolio rebalancing activities, by generating most, if not all, of the **annual cash needs**.
- Use synthetic instruments such as index futures throughout the year to **rebalance** or achieve desired economic exposure between and within marketable asset classes, and to take advantage of market opportunities.
- Consider **municipal bonds** as a non-taxable source of interest income.
- Be thoughtful of how and when to **liquidate** share distributions from private managers.
- Seek to **harvest losses** across strategies continuously throughout the year.
- Evaluate moving passive allocations to a **tax-managed separate account** designed to generate capital losses and defer gains.

GETTING AHEAD OF A TAX RATE INCREASE

Language in two of the three bills introduced to the House of Representatives states that the tax increase will go into effect the year following passage. Depending on which, if any, piece of legislation looks likely to be enacted in 2025, to the extent that it will go into effect in calendar year 2026, current in-scope endowments will have a strong incentive to realize as many capital gains as possible at the 1.4% NII tax rate prior to year-end, and both current and prospective in scope endowments should seek opportunities to re-set the cost basis of appreciated holdings. Further, endowments should consider accelerating anticipated changes to their asset allocation by the end of December. The motivation behind all of these activities is to realize as many gains as possible under the lower rate.

POST-ENACTMENT: DEFINE AND REALIZE CAPITAL GAINS EARLY

Most endowments we've engaged with have stated that they do not plan to meaningfully alter their asset allocation in the wake of an increase to the endowment tax. This makes sense, since teams have spent years modeling and assessing asset class returns, risk, correlations and liquidity, weighing the various data with a goal of maximizing absolute and/or risk-adjusted portfolio returns while preserving the ability of the endowment to support the needs of the institution.

It's also no surprise that most larger endowments today maintain a large allocation to illiquid, private asset classes. Absent a meaningful structural change in asset allocation, which would take years, we assume that endowments will maintain their existing asset allocation. Further, the realization of capital gains from the private asset book will largely ebb and flow based on factors outside of the control of endowments. Therefore, two key levers endowment managers must address center around sourcing and managing liquidity and rebalancing marketable portfolio exposures.

Liquidity management

Capital gains are realized following the sale of an asset at a price higher than its cost basis. For institutional investors, capital gains can be realized by the investor themselves (direct) or by the underlying investment managers (indirect). These direct realized capital gains are often a result of selling non-manager holdings, such as ETFs or index funds, or trimming manager positions to generate periodic liquidity to support the fund's obligations to the institution, or to facilitate manager contributions and capital calls. These sales tend to occur around the timing of cash payments to the institution and the opening of external manager liquidity windows, often quarterly.

Because the need for cash is largely independent of the market environment, at least that which supports the institution, endowment managers liquidating positions over the course of a year are subject to capital gains whose magnitude is a function of how well the underlying market or strategy has performed. At the beginning of a calendar year endowment staff likely have a very good estimate of their cash obligations over the ensuing 12 months. As markets tend to rise over time, it follows that a periodic liquidation schedule will result in higher capital gains as compared to generating all the required cash at the beginning of the year.

In isolation, if endowments are seeking to optimize for minimizing direct capital gains, we believe that they should consider generating all their anticipated annual liquidity requirements at the beginning of the year. This will result in a clear definition of the direct realized capital gains, giving endowment managers a longer period over which to assess and plan for the anticipated tax bill.

Importantly, the sources of liquidity should obviously be chosen to minimize capital gains. Selling higher-basis positions and trimming under-performing managers will minimize capital gains realization. But, to the extent various positions or asset classes are out of balance, these larger liquidity sourcing events can be managed in tandem with aligning strategies and asset classes to a desired target.

A strategy of generating a year's worth of liquidity needs, which could include sourcing funds from under-performing managers, does present some unique challenges. First, what should endowments do with the cash that is generated at the beginning of the year? To the extent that obligations to the sponsoring institution can be accelerated, this will eliminate the expected opportunity cost of foregone risk premia. Alternatively, excess cash can be invested in low-cost passive instruments or equitized via futures to maximize liquidity while maintaining equity market participation. Second, sourcing funds from under-performing managers may magnify deviations across strategies, leading to an unbalanced position across or within a given asset class. Use of derivative overlay to adjust exposures can serve as a valuable means of quickly and efficiently remaining within desired limits.

Portfolio rebalancing

Concurrent with generating cash needs less frequently, endowments should use those liquidity events to rebalance marketable asset classes. Then, between these periods, a derivative overlay such as index futures can be used to adjust economic exposures. To the extent a given manager strategy or asset class has appreciated above a threshold, instead of trimming physical positions and realizing an expected capital gain, derivatives can aid in aligning portfolio exposures without the need to adjust manager holdings. Keep in mind that the change in value from the derivative positions will generate associated capital gains or losses as these instruments are market- to-market each day. But it's been our experience that rebalancing via derivatives has delivered both superior results and increased flexibility. Modeling various scenarios to compare physical versus synthetic rebalancing can be useful in better understanding the potential tradeoffs.

CONSIDER TAX-FREE SOURCES OF INCOME

In the guidance the IRS issued in October 2020, they clarified that interest from state and local bonds is not subject to inclusion in NII. Municipal bonds may serve as useful instruments for managing short-term liquidity, although endowments will need to evaluate the tax equivalent yield of various municipal bonds/strategies once a final tax rate is determined. While used extensively by individual investors, municipal bonds are widely employed by taxable institutions such as insurance companies, nuclear decommissioning trusts (NDTs), and a variety of settlement trusts (e.g. Asbestos Trusts).

USE PRUDENCE IN LIQUIDATING SHARE DISTRIBUTIONS

Over the past several years we've worked with several investors whose private equity managers have distributed significantly appreciated shares of stock following an IPO. In many cases these shares represent an outsized, idiosyncratic risk. As a result, the investor sought to quickly liquidate a meaningful portion of the holdings, or structure an options-based hedge to mitigate some of the potential downside.

We'd expect most of the value of distributed shares to be capital gains. Thus, endowments should be measured in executing a liquidation schedule such that capital gains realization can be optimized in the context of the broad portfolio. The use of options in tandem with the liquidation schedule can potentially mitigate downside risk of holding the position longer than one would in the absence of a tax. But these strategies come at a cost: either explicitly via an insurance-like payment for outright downside mitigation, or implicitly via the opportunity cost of selling away upside participation.

ACTIVELY SEEK TO HARVEST PORTFOLIO VOLATILITY

Investors tend to consider historical market returns in yearly chunks: The market was up 25.9% in 2009, or down 18% in 2022. Yet we know that markets do not move in a straight line; in every year since 1980 there has been an intra-year drawdown which has averaged -13.9%.[1] Over the course of every year, there will likely be opportunities to liquidate or trim investments that have fallen in value, to either realize capital losses or minimize capital gains, while seeking to re-deploy capital to other, perhaps similar, strategies.

This tax-loss harvesting strategy runs counter to how most institutional investors manage their assets but is commonplace for individual investors subject to taxes. It clearly increases the frequency of portfolio adjustments and requires a greater level of portfolio monitoring, and only is applicable for liquid, marketable holdings assets, which tend to comprise a small portion of endowment portfolios. However, an active tax-loss harvesting strategy can be a powerful tool to defer capital gains into future years. This strategy can be applied both at the portfolio and asset class level. Individual investors often use this tax-loss harvesting at the individual stock level, which isn't realistic for institutional investors as they employ external managers, but replacing passive holdings with an active tax-loss-harvesting index strategy can potentially deliver meaningful value by delivering capital losses, which can be used to offset gains from other investments.

MOVE PASSIVE ALLOCATIONS TO A TAX-MANAGED SEPARATE ACCOUNT

As described above, tax-loss harvesting can be a powerful tool in an investor's toolkit for managing the pace of capital gain realization and potentially realize capital losses. The challenge for institutional investors, who generally outsource management of funds to external managers, is the lack of control over buy and sell decisions of individual securities. This hurdle can be overcome by using a professionally managed strategy designed to deliver capital losses.

Most institutional investors use passive vehicles (ETFs, index funds) to manage marginal liquidity or as a general rebalancing vehicle. While these instruments are relatively tax efficient in that they seek to minimize capital distributions, they aren't designed to produce any additional tax benefits to investors. To capture the expected advantage of harnessing capital losses an investor can move from a passive instrument to a separately managed account, in which many individual securities in an index are held directly, and thus provides the structure from which continuous tax-loss harvesting can achieved.

For example, in a direct indexing portfolio, the investor will own a large percentage of the underlying stocks in an index, such as the S&P 500®. The direct indexing manager will continuously select loss-maximizing positions for sale and replace these with other securities in the index with similar characteristics, seeking to track the underlying benchmark over the course of a year.

The two objectives of a direct indexing strategy are to be the market and to beat the market after taxes (provide tax alpha). These goals may seem in conflict, but given the large number of securities in most widely used indexes, owning a subset of index constituents, optimized to preserve the risk-return profile of the benchmark, offers the flexibility to continuously harvest losses. The trade-off as compared to a commingled passive vehicle is increased tracking error, whose expected value is a function of the size of the account, chosen benchmark and capital loss goals.

[1]Source: Standard & Poor's. As of 3/31/25.

As mentioned previously, realized capital gains cannot be effectively eliminated; simply deferred to a point in the future. And that is exactly what a direct indexing strategy seeks to accomplish. Over the course of approximately seven years, a direct indexing portfolio becomes 'seasoned' as most opportunities to harvest losses become exhausted. Over this entire period, approximately 40% to 60% of the initial portfolio's value can be harvested as losses, with approximately 10% coming in the first year, 8-9% in year two, etc.

For example, given a $100M starting portfolio value, in the first year we would expect to generate $10M in capital losses, which can be used to offset gains from other parts of the portfolio. Then, in year two the capital losses would decrease to $8M, and so on. After approximately seven years, limited additional capital losses are expected, at which point the portfolio essentially turns into more passive holding with less after-tax benefit.

This example is illustrative of a long-only direct indexing strategy. There is the opportunity to magnify the amount of capital losses by using a long/short version (130/30, 150/50, 200/100), which could potentially triple the annual capital losses. This leveraged strategy can also be used to transition a seasoned long-only direct indexing portfolio after few additional capital losses are expected to be harvested. Importantly, the expected tracking error for leveraged versions of direct indexing scale with the amount of leverage used.

Direct indexing is a very developed strategy that has been employed extensively over the past three decades and is used extensively by private wealth advisors and taxable institutions. Virtually any equity benchmark can serve as the base for a portfolio, but the strategy extends into fixed income as well as baskets of ETFs, although the expected amount of harvested capital losses is lower for non-equity portfolios. Additionally, many investors choose to tailor the underlying portfolio to better align with their objectives. Blending multiple indexes, custom factors, tilts, screens and even active manager models, are all possible choices in a direct indexing strategy.

Conclusion

As the landscape of the Endowment Tax evolves, institutions must remain vigilant and proactive in their tax planning strategies. By understanding the components of NII and exploring innovative approaches to managing capital gains, endowment managers can better position their institutions to navigate potential tax increases. The focus should remain on strategic asset management and liquidity planning to minimize the tax burden while supporting the institution's financial goals.

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