Parametric

Private Foundation Tax: Thoughts and Considerations for Institutional Investors

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The Tax Reform Act of 1969 significantly altered the landscape for tax-exempt organizations by drawing a distinction between public charities and private foundations. Importantly, the legislation sought to compel private foundations to "share some of the burden of paying the cost of government" by establishing a 4% excise tax on net investment income. The tax rate was reduced to 2% in the Tax Reform Act of 1978 and finally to 1.39% in 2020. The House recently voted to advance a bill which proposes a tiered tax scheme, which imposes an increased rate for private foundations with assets of $50 million or more, ranging from 2.78% to as high as 10%.

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 (NII), the amount on which the tax is applied. Second, we'll discuss strategies and considerations for foundation managers that focus on the two components that add to NII—although we won't touch on allowable deductions, an area better left to investment staff, administrators and advisors. We must emphasize that we're not tax advisors. Our intent is to highlight various strategies and approaches that foundations may consider in seeking to better prepare themselves in the event a probable change to the tax code.

Defining net investment income

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

Gross investment income:

Income that includes interest, dividends, payments on security loans and royalties, but excludes UBTI and interest from tax-exempt state and local bonds.

Realized capital gains:

The sale price of a security minus its cost basis.

Allowable deductions:

Expenses paid or incurred for the production or collection of gross investment income, or the management, conservation or maintenance of property held to produce that income.

Internal Revenue Service guidance

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.
- Royalty income from patents, copyrights and other intellectual property, to the extent those assets resulted from the work of staff 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, 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 losses may be used to offset capital gains, but only to the extent of those gains in a given year.
- Capital losses exceeding capital gains may not be carried back or forward to other tax years.

Summary of proposed legislation

On May 22, 2025, the House passed the One Big Beautiful Bill Act. The bill includes changes to the tax on private foundations, leaving the existing 1.39% rate in place for those with assets less than $50M. It also adds three additional tiers at 2.78%, 5% and 10% for institutions with assets of $50 million, $250 million and $5 billion, respectively. The proposed changes, if passed as-is, would go into effect in tax year 2026.

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 foundation tax, not only to underscore the magnitude of such a change, but to aid in framing a discussion of potential strategies that foundation managers may consider in the wake of an adjustment.

Following our discussions with numerous foundations, we estimate that the current 1.39% tax has resulted in a two- to 12-basis-point (bps) annual headwind, which implies a total NII as a percentage of assets of 1.4% to 8.6% *(2 bps/1.39% = 1.4%; 12 bps/1.39% = 8.6%)*. This is obviously a large range, and several factors—including market environment, asset allocation, manager contributions and distributions, and overall liquidity profile—can influence the exact percentage meaningfully. For simplicity's sake, we assume a midpoint of that range, or 5%, as a reasonable estimate of the annual NII as a percentage of total assets.

DIAGRAM 1: PROPOSED CHANGES TO THE TAX ON PRIVATE FOUNDATIONS

AGGREGATE FMV OF ASSETS	PROPOSED RATE
<$50M	1.39% (current rate)
$50M to <$250M	2.78%
$250M to <$5B	5%
>$5B	10%
Effective date	1/1/2026

Source: House Ways and Means Committee, 5/19/2025.

With interest, dividends and capital gains as the components to NII, it should be unsurprising that capital gains are its largest contributing factor on average. While interest income may comprise most of the long-term total return on fixed income investments, foundations typically maintain larger allocations to public and private equity. Dividends do contribute meaningfully to long-term expected equity returns, but capital appreciation has historically driven the overall equity risk premium. This means 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 that foundations 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 foundation 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's no silver bullet when it comes to avoiding realized capital gains taxes. Markets tend to rise over time, so when an investor eventually sells an asset, they'll realize a capital gain and, barring a change in the tax code, pay taxes on it. Most strategies and tactics that foundations may employ will therefore be centered on tax deferral, not tax avoidance. Some of these strategies may run counter to existing investment processes or philosophy.

Let's go back to the broad estimate of annual NII of 5%. At the current tax rate of 1.39%, this equals an annual tax burden of seven bps at the fund level, which can be considered a nuisance for most. With proposed tax increases ranging from 2.89% to 10%, the burden would jump to between 14 and 50 bps.

Given meaningful allocations to illiquid, private assets, a clear challenge for larger foundations is how to influence and manage the realization of capital gains using strategies that only apply to their marketable investments. One of the clear trade-offs associated with private investments is the loss of direct gain realization for higher expected long-term returns.

Possible tactics and strategies for foundations

SUMMARY

- Seek to **reset investments to a higher cost basis** prior to the tax change taking effect.
- **Realize as many capital gains as necessary** early in the year, ideally in conjunction with portfolio rebalancing activities, by generating most (if not all) 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.
- **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.
- **Consider moving passive allocations** to a tax-managed account designed to generate capital losses and defer gains.

GETTING AHEAD OF A TAX RATE INCREASE

The bill states that the tax increase will go into effect the year following passage. Assuming the existing language remains and a bill passes this year, foundations facing a tax increase will have a strong incentive to realize as many capital gains as possible at the 1.39% NII tax rate prior to year-end while also resetting the cost basis of appreciated holdings. We believe foundations should consider accelerating anticipated changes to their asset allocation by the end of December. The motivation behind these activities is to realize as many gains as possible under the lower rate.

POST-ENACTMENT: DEFINE AND REALIZE CAPITAL GAINS EARLY

Many foundation have stated that they don't plan to meaningfully alter their asset allocation in the wake of an increase to the tax. This makes sense, since teams have spent years modeling and assessing asset class returns, risk, correlations and liquidity, aiming to maximize absolute and risk-adjusted portfolio returns while preserving the ability of the foundation to support the needs of the institution.

It's also no surprise that most larger foundations today maintain a large allocation to illiquid, private asset classes. Absent a meaningful structural change in asset allocation, which would take years, we assume foundations will maintain their existing asset allocation. That said, the realization of capital gains from the private asset book will largely ebb and flow based on factors outside of the control of foundations. This gives foundation manages two key levers to address: sourcing and managing liquidity and rebalancing marketable portfolio exposures.

Liquidity management

Investors may realize capital gains after selling an asset at a price higher than its cost basis. Institutional investors can realize capital gains themselves (direct) or pass them on to their underlying investment managers (indirect). Direct realized capital gains may result from a number of activities:

- Selling non-manager holdings, such as ETFs or index funds
- Trimming manager positions to generate periodic liquidity to support the fund's obligations to the institution
- Facilitating manager contributions and capital calls

These sales tend to occur around the timing of generating capital for grants and the opening of external manager liquidity windows, often quarterly.

Because the need for cash is largely independent of the market environment, foundation 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, foundation staff likely have a very good estimate of their cash obligations over the ensuing 12 months. As markets tend to rise over time, it makes sense that a periodic liquidation schedule will result in higher capital gains, compared with generating all the required cash at the beginning of the year.

All other things being equal, if foundations seek to minimize direct capital gains, we believe 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 foundation managers a longer period over which to assess and plan for the anticipated tax bill. Of course, managers should choose liquidity sources likelier to minimize capital gains. Selling higher-basis positions and trimming underperforming managers will minimize realization. However, to the extent various positions or asset classes are out of balance, managers can execute larger liquidity-sourcing events 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 underperforming managers, presents some unique challenges. First, what should foundations do with the cash that is generated at the beginning of the year? To the extent that managers can accelerate obligations this will eliminate the expected opportunity cost of foregone risk premia. Alternatively, managers can invest excess cash in low-cost passive instruments or equitize them using futures, with the goal of maximizing liquidity while maintaining equity market participation. Second, sourcing funds from underperforming managers may magnify deviations across strategies, leading to an unbalanced position across or within a given asset class. Using a derivative overlay to adjust exposures may be a valuable means of quickly and efficiently remaining within desired limits.

Portfolio rebalancing

Along with generating cash needs less frequently, foundations can use liquidity events to rebalance marketable asset classes. Between these periods, managers can use a derivative overlay such as index futures 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, since these instruments are mark-to-market. But it's been our experience that rebalancing via derivatives has delivered both superior results and increased flexibility. It's useful to model various comparisons between physical and synthetic rebalancing in order to better understand the potential trade-offs.

CONSIDER TAX-FREE SOURCES OF INCOME

Because interest from state and local bonds isn't subject to inclusion in NII, municipal bonds may serve as useful instruments for managing short-term liquidity. Foundations will still need to evaluate the tax-equivalent yield of various municipal bond strategies after determining the final tax rate. While individual investors use municipal bonds extensively, taxable institutions such as insurance companies and settlement trusts are likeliest to choose munis.

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. Foundations should be cautious in executing a liquidation schedule, aiming to optimize capital gains realization in the context of the broad portfolio. The use of options in tandem with the liquidation schedule may mitigate the 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 and down 18% in 2022. But we know that markets don't move in a straight line. In every year since 1980, markets have experienced an intra-year drawdown of -13.9% on average.1 Over the course of every year, investors will likely see opportunities to liquidate or trim investments that have fallen in value, either to realize losses or minimize gains while seeking to redeploy capital to other strategies. This tax-loss harvesting (TLH) strategy runs counter to how most institutional investors manage their assets, but it's 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 assets, which tend to comprise a small portion of foundation portfolios.

However, an active TLH 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 TLH at the individual stock level, which isn't realistic for institutional investors who employ external managers. Replacing passive holdings with an active TLH index strategy can potentially deliver meaningful value by delivering capital losses, which foundation managers can use to offset gains from other investments.

MOVE PASSIVE ALLOCATIONS TO A TAX-MANAGED SEPARATE ACCOUNT

As described above, TLH can be a powerful tool in an investor's toolkit for managing the pace of capital gain and loss realization. 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. Foundations can overcome this hurdle by using a professionally managed strategy designed to deliver capital losses.

Most institutional investors use passive vehicles, like ETFs and index mutual 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 (SMA). An SMA allows the investor to directly hold individual securities in a benchmark, providing the direct indexing structure designed to generate continuous TLH. 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 (1) be the market and (2) beat the market after taxes. 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 compared with 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, investors can't effectively eliminate realized capital gains altogether, but they can defer gain realization into the future—exactly what a direct indexing strategy seeks to accomplish. Over the course of approximately seven to 10 years, a direct indexing portfolio becomes "seasoned" as the portfolio manager uses up most opportunities to harvest losses. During this period, the investor can harvest approximately 40% to 60% of the initial portfolio's value as losses, with approximately 10% coming in the first year, 8% to 9% in year two, and so on. For example, given a starting portfolio value of $100 million, we'd expect to generate $10 million in capital losses in the first year, which can be used to offset gains from other parts of the portfolio. The capital losses would decrease to $8 million in the second year. After approximately seven more years, we'd expect limited additional capital losses, at which point the portfolio essentially turns into a more passive holding with less after-tax benefit.

This example is illustrative of a long-only direct indexing strategy. Investors also have 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 annual capital losses. Investors can use this leveraged strategy to transition a seasoned long-only direct indexing portfolio. 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 we've employed extensively over the past three decades for 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 and baskets of ETFs, although we expect lower harvested capital losses for non-equity portfolios. Many investors also 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 tax landscape impacting private foundations 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, foundation 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.

About Parametric

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