When Tax-Exempt Isn't Really Tax-Exempt—Minimizing Excise Tax on Private Foundations

Many taxable investors have realized significant benefit from sophisticated portfolio techniques like tax-loss harvesting, a variation on standard indexing that aims, on average, to capture the pre-tax returns of a benchmark while generating tax benefits that improve after-tax return by lowering tax liability. Though fully tax-exempt entities usually can't benefit from such strategies, private foundations are still subject to an excise tax on investment income that can be as high as 2%, which ends up exacting a tax toll that may be less trivial than one might expect. The table below shows the types of tax-exempt entities subject to the excise tax:

Nonprofits Subject to Excise Tax	Nonprofits Exempt from Excise Tax
Private foundations *(Rate is 2% unless certain distribution requirements are met, which reduce the excise tax rate to 1%.)*	• Religious institutions • Educational institutions that serve as public charities • Hospitals • Federal government entities • Defined benefit plans, public or private • Public foundations

For private foundations, this excise tax can prove significant. We've seen situations where foundations have ignored the tax treatment, thus lowering what they could grant to their programs and giving that money to the government instead of furthering the foundation's mission and impact goals by giving it to grant recipients in need. The tax rate may be low enough that it's a trivial issue for rebalancing a smaller private foundation endowment, of, say, $5 million. For large endowments, however, even 2% in avoidable excise tax can make a big difference. For example, a $100 million active stock portfolio within an endowment might generate 4% of that total in gains every year.[1] At the 2% excise tax rate, $4 million a year in gains triggers an excise tax bite of $80,000 a year. Major rebalancing can trigger significantly larger excise tax costs.

Are excise tax savings worth the hassle? For smaller foundations or those who use tax-efficient strategies like traditional indexing, the benefit may be so small as to not be worthwhile. Furthermore, any additional costs incurred due to loss harvesting need to be carefully considered since the benefit of loss harvesting to offset the excise tax is so much lower for a private foundation than for a top-bracket individual investor, who pays taxes at rates as high as 50% instead of just 2%.

Nonetheless, private foundations that currently view the excise tax as an unavoidable cost of doing business may be able to wring out a little extra benefit for their philanthropic programs simply by more actively managing their tax liability. As a side note, even private foundations who don't opt for loss harvesting can manage their excise tax liability more effectively by donating appreciated securities to their grant recipients, exactly the same way taxable individuals can. Wherever tax savings can be gained by more conscious management, the end beneficiary will be the very grant recipients that private foundations were set up to serve.

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Endnotes

[1] Based on data from Morningstar as of 12/31/2014 comparing the pre-tax and after-tax returns of all actively managed US equity mutual funds that existed throughout the trailing 20-year period, excluding tax effects of dividends and liquidation. Data reflect 2014 maximum federal and high-tax state rates, with California as a proxy for high-tax states. One-third of gains were presumed to be short-term, with two-thirds presumed long-term.

Disclosure

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With respect to the description of any investment strategies, simulations, or investment recommendations, we cannot provide any assurances that they will perform as expected and as described in our materials. Past performance is not an indicator of future results. Every investment program has the potential for loss as well as gain. Investors who do not have off-setting capital gains and income would not benefit from loss harvesting. A foundation with no excise tax liabilities would not receive any benefit from tax management. One paying only the 1% excise tax rate would receive only half the benefits described for those subject to the 2% rate.

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