FOUNDATIONSOURCE

5 Things Private Foundations Should Consider in a Rising Market

KEY CONSIDERATIONS FOR LONG-TERM SUSTAINABILITY

Since reaching its low point in October 2022, the stock market has been on a steady rise. A bull market is always welcome because it has the potential to create more funds for private foundations to make an impact. But rising markets can create specific challenges and opportunities within a foundation that must be examined and managed carefully for optimum effect.

Here are five key considerations that foundations and advisors to charitable individuals should keep in mind as they navigate the current environment and look for ways to reposition their portfolios for long-term sustainability.

1 Make In-Kind Gifts of Highly Appreciated Assets

Bull markets can create significant built-in gains for investors. Liquidating those positions would result in capital gains tax, but those can potentially be sidestepped with in-kind gifts to charities and foundations. Those gifts can be larger as a result, creating a bigger impact. However, it's important to note that the tax benefits can vary significantly depending on the type of asset donated.

Consider this example with publicly traded stock: Let's assume a donor to a private foundation has 100 shares of stock with a current market value of $10,000 and an original cost basis of $4,184, resulting in a capital gain of $5,816. If the donor were to sell the shares, the capital gains tax would total $1,163 (assuming a 20% rate), leaving just $8,837 available for the donation.

But transferring those publicly traded shares directly to a charity or foundation allows the donor to contribute the full $10,000 amount without any tax consequence—about 13.2% more. Additionally, individual donors may be able to claim a tax deduction for the full market value of the donated shares—depending on their tax situation.

While publicly traded securities typically offer the most favorable tax treatment, other types of appreciated assets can also be used for in-kind gifts, including real estate and privately held business interests.

For instance, donations of non-publicly traded assets will typically limit the donor to a cost basis deduction (as compared to a fair market value deduction), so the tax benefit may be less substantial than with publicly traded securities.

2 Harvest Capital Losses

While it may seem counterintuitive in a rising market, there may still be opportunities to harvest capital losses. Even in a bull market, there are bound to be some companies and sectors that lag. Selling underperforming assets can lock in losses, which can be used to offset gains elsewhere in the foundation's portfolio.

For example, if a foundation has a stock that has decreased in value from $10,000 to $8,000, selling it would result in a $2,000 realized loss. If the foundation has another asset that appreciated by $2,000, they can offset that gain with the loss. By potentially reducing the foundation's overall tax liability, more funds can be freed for charitable purposes.

3 Manage MDRs

Under IRS rules, a foundation must pay out roughly 5% of its prior year's average assets, known as the minimum distribution requirement (MDR), each year. Accordingly, when assets increase, the following year's MDR will increase in tandem which could potentially strain a foundation's resources as it evaluates the best methods of deploying the additional capital.

However, bull markets are also an opportunity to manage foundation assets for the long term. Foundations can take advantage of their growing portfolios by strategically over-granting in strong years to create a buffer for leaner times. By distributing more than the required 5%, foundations can keep the amount above the MDR in reserve for up to five years. These 'credits' can be used to meet the MDR in future years, which can be valuable in down markets, alleviating the need to sell part of the portfolio at a loss to meet the MDR, which can potentially eat into the corpus, or principal, of the foundation.

4 Pay Attention to Liquidity

In a rising market, non-income-producing assets like private company stock or real estate may still experience appreciation, which can increase a foundation's MDR, but without providing the income needed to meet that requirement. If not managed well, that can lead to a liquidity crunch.

Establishing and maintaining a clear investment policy can help ensure that portfolios are managed in a way that maintains sufficient liquidity for a foundation's distribution requirement.

Foundations should also ensure they comply with state-specific prudent investor rules. These rules require fiduciaries to act as careful investors would, considering the purposes, terms, distribution requirements and other circumstances of the foundation. For example, foundation assets should be invested for diversification to minimize the risk of large losses. Foundations and advisors should regularly review their investments and adjust their strategy when the portfolio is misaligned with the investment policy statement.

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5 Be Cautious with Margin Trading

As market valuations increase, it may be tempting to trade on margin. However, foundations should exercise caution because margin trading can generate Unrelated Business Taxable Income (UBTI), which carries significant consequences for foundations. This may require filing a separate 990-T tax return, in addition to the usual 990-PF. In addition, the tax rate for UBTI is subject to taxation at the higher, for-profit rates, rather than the 1.39% excise tax that typically applies to a foundation's net investment income. What's more, calculations for UBTI can be complex, necessitating working with a specialist.

Instead of margin trading, foundations can explore other approaches to maximize returns. These include strategic asset allocation, mission-related investments, loans and recoverable grants and other types of impact investments that could potentially generate a return on investment.

Planning for Impact

Like a bear market, a rising market requires careful planning and strategic forethought. Foundations and advisors must regularly review their investment policies, distribution strategies and tax implications to ensure that they're maximizing their charitable impact while maintaining their financial health.

Have questions about how to navigate the bull market for your foundation?

Our team is here to help! Contact us to schedule a consultation.

ABOUT FOUNDATION SOURCE

Foundation Source empowers people and companies to create a better world through philanthropy. We make giving easier for more than 4,000 charitable organizations with innovative technology backed by philanthropic expertise.

HAVE A QUESTION?

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