Could Proposed Endowment Tax Increase Secondary Sales?

Summary

- The proposed tax changes may cause impacted investors to look for ways to avoid paying taxes on gains by selling secondaries sales in H2 2025 or early 2026. For endowments, the proposed changes would apply to taxable years beginning after December 31, 2025. Many endowments' tax year would begin on July 1, 2026, meaning any gains realized on or before June 30, 2026, would not be taxed.
- Investors previously unwilling to accept a discount for an LP secondary sale may now be motivated to sell today at a discount instead of paying a tax in the future.
- Those most motivated to sell are LPs who believe they will be paying high taxes, in particular the 21% rate.
- The higher the unrealized gains, the larger the discount an LP would be willing to accept to avoid paying a tax.
- The average LP buyout secondary sold for 94% in 2024.[1]

Overview

The proposed tax tiers in the 'Big Beautiful Bill' raise the excise tax on net investment income to upwards of 21% for endowments and 10% for private foundations. If enacted, these new tax rates may cause impacted investors to take certain investment actions to avoid paying the tax before the changes are in place.

Because of the magnitude of the tax at the highest tier, investors are incentivized to realize large gains before the tax is in place. Potential strategies may include completing an LP secondary sale, or the sale of a real estate property.

Although LP secondary sales are often sold at a discount, with a potential tax looming, investors may be willing to take that discount today versus pay the tax in following years.

LPs who would be the most motivated to sell:

- Would be in the highest bracket (tax rate is high)
- Have an asset with high unrealized gains with low cost basis (large amount of gains subject to tax)
- Limited future potential asset value growth (less downside in selling today versus in the future)

Several Ivy League schools already have secondaries out for sale. Could we see others in the proposed 21% or even the 14% tier come to market? Those potentially in the 21% tier include Princeton, Stanford and MIT, some potential 14% tier include New England Small College Athletic Conference (NESCAC) peers Amherst College, Bowdoin College and Williams College, along with Pomona College, Grinnell College, California Institute of Technology and Swarthmore College.[2]

The Math

The proposed tax tiers are applied to net investment income of an endowment or foundation, meaning realized gains (i.e., the value above the cost basis) will be taxed at the new rate.

For secondaries, pricing is typically a discount to net asset value. Before the tax, the discount may have not been attractive as the alternative was to continue to hold and pay a marginal 1.4% on gains in the future. However, if the alternative is now paying a tax in the future, paying a certain discount today is more attractive.

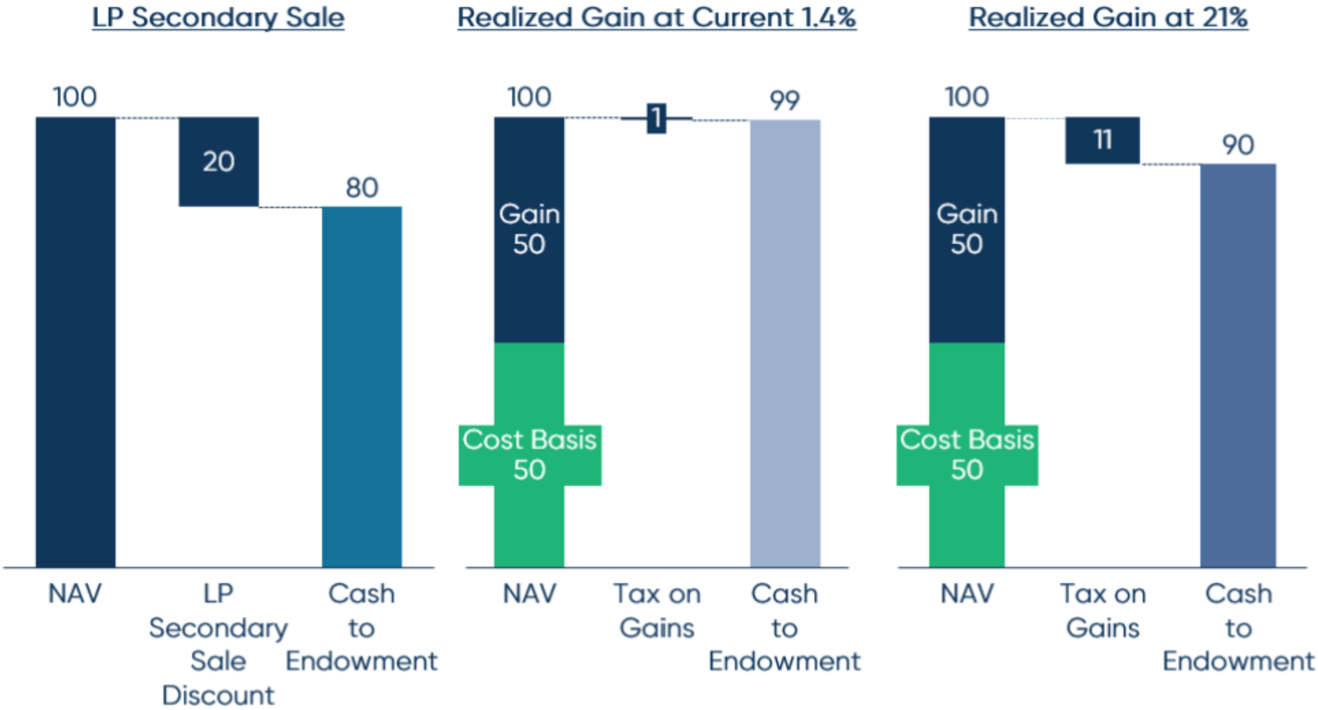
Example: Selling a Secondary at 20% Discount vs. Paying Tax

In the example below, we assume there is an LP interest worth $100.

LP Secondary Sale: Today, a secondary sale would require an estimated 20% discount to current value, meaning the seller would lose $20 in the sale, receiving only $80.

Current 1.4% Tax: That same $100 LP interest is actually comprised of $50 of unrealized gains and $50 of cost basis (a 2x value). When realized, only the $50 gain is taxed, creating a 70 cent loss for this investor. The investor takes home $99.30.

Proposed 21% Tax: Under the new proposed regime, that same LP interest now losses $10.50 to tax, leaving the investor with $89.50.

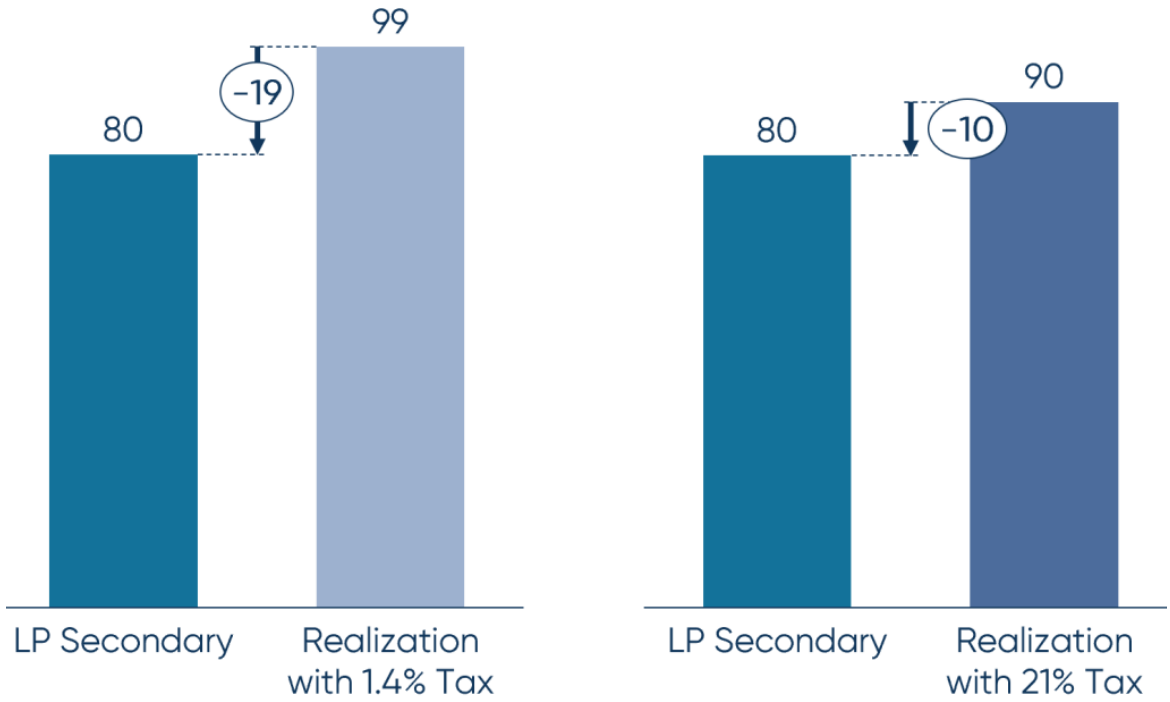


Source: TIFF Analysis.

In the current tax regime, there is still a large differential between the discount loss and the tax loss. Our example shows the minimal impact of the current 1.4% tax.

However, with the proposed tax rates, suddenly it costs a lot to realize gains. In our same example, proceeds from a secondary sale are now closer to the post-tax proceeds. Investors are doing to same math to see if it is more beneficial for them to sell anything today versus in the future.

Cash to Endowment After Tax or Discount



Source: TIFF Analysis.

Depending on the tax tier and the size of unrealized gain as a multiple of cost basis, an investor would be indifferent to paying a certain discount versus paying the tax. The table below illustrates the secondary discount at which an LP investor would be indifferent, based on the various tax tiers and the size of the unrealized gain.

What Secondary Sale Discount is Equivalent to Paying Tax

Endowment Tax Tiers

	Multiple of Current NAV/Cost Basis					
Tax Rate	1.0x	1.5x	2.0x	2.5x	3.0x	3.5x
21.0%	-	7.0%	10.5%	12.6%	14.0%	15.0%
14.0%	-	4.7%	7.0%	8.4%	9.3%	10.0%
7.0%	-	2.3%	3.5%	4.2%	4.7%	5.0%
1.4%	-	0.5%	0.7%	0.8%	0.9%	1.0%

Foundation Tax Tiers

	Multiple of Current NAV/Cost Basis					
Tax Rate	1.0x	1.5x	2.0x	2.5x	3.0x	3.5x
10.0%	-	3.3%	5.0%	6.0%	6.7%	7.1%
5.0%	-	1.7%	2.5%	3.0%	3.3%	3.6%
2.78%	-	0.9%	1.4%	1.7%	1.9%	2.0%
1.38%	-	0.5%	0.7%	0.8%	0.9%	1.0%

Source: TIFF Analysis.

Conclusion

In particular the highest tier of 21%, the proposed endowment tax tiers are poised to influence investment behaviors and change financial trade-offs. As impacted investors seek to optimize their financial outcomes in light of the impending tax changes, the market may witness a surge in secondary transactions — reshaping the landscape of endowment and foundation investment strategies.

It is imperative for stakeholders to closely monitor these developments and consider the implications for their own investment portfolios and tax planning strategies. TIFF will continue to provide updates on the ever-evolving landscape and perspective on how nonprofits can navigate the potential financial challenges.

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Footnotes

1. Jefferies, "Global Secondary Market Review," January 2025.
2. https://www.ai-cio.com/news/the-private-universities-affected-by-proposed-tiered-endowment-tax/

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June 5, 2025