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Maximizing Tax Benefits Through Charitable Giving

Rey Santodomingo, CFA, *Managing Director of Investment Strategy*

The process of finding a charity and giving it money seems simple. However, like portfolio asset allocation, the gifting process is nuanced. Slightly different approaches can yield dramatically different tax benefits for the charity-minded investor. Let's look at the comparable after-tax benefits of giving cash, giving securities, and giving securities while simultaneously replenishing a [tax-managed portfolio](#) with cash.

Before we begin, let's discuss how charitable donations are currently viewed under the tax code.

How much charitable giving is tax deductible?

First, charitable donations are deductible only for those taxpayers who itemize deductions. The recent tax changes implemented under the 2017 Tax Cuts and Jobs Act have increased the standard federal deduction—to \$12,200 for individuals and \$24,400 for married couples—which has made it more difficult for individuals to itemize their deductions (with the exception of high-net-worth investors who may be less impacted by this tax change).

Second, the charitable giving deduction is the same whether the donation is made in cash or stock. However, investors should keep in mind that the stock must be held for over a year before it's donated and is limited to 30% of the taxpayer's adjusted gross income (AGI).

Let's now take a look at tax-efficient charitable giving methods.

Gifting cash

Cash is a convenient gift because it's easy for donors to write checks for charities to deposit. The gift is also tax deductible in the current tax year. Consider a charitable gift of \$50,000 in cash. Assuming the highest marginal tax rates of 37%, the donation can reduce the taxpayer's AGI by \$50,000, resulting in a tax bill that's \$18,500 lower ($\$50,000 \times 37\% = \$18,500$).

Gifting securities

Having a highly appreciated portfolio position is great—until the investor is ready to sell that position. Given a 23.8% federal capital gains tax—which factors in the 3.8% Medicare surtax that applies to high earners—selling highly appreciated positions may be detrimental to investors. A way to completely avoid this liability is [donating the stock to charity](#), which enables investors to make their desired donation, deducts its value from their AGI, and avoids the capital gains tax that gets applied to stock sales.

To analyze the tax benefits of charitable giving, we'll assume the same \$50,000 gift amount that we used in the cash example, but instead of cash we'll assume the \$50,000 gift consists of securities that have appreciated by 100% (therefore, having an initial cost of \$25,000). Keep in mind the IRS allows investors to take deductions from donated securities only if the securities were held for at least one year and the dollar amount sold is less than 30% of the investor's AGI.

The benefit of giving securities over cash is that in addition to providing charities with the funds they need, the investor also avoids the tax liability embedded in the investment. In the example with the securities gift of \$50,000, the embedded gain of \$25,000 represents a tax liability of close to \$6,000, assuming the highest capital gains tax rate of 23.8%. By giving these securities to charity, the investor avoids this capital gains tax. The charity is also free to sell the security tax free, making the gift as good as cash. Similar to the cash gift, the taxpayer in this example also gets a same-year tax deduction of \$50,000, which reduces their AGI.



Gifting securities with cash replenishes

In the context of a **tax-managed portfolio**, investors can realize additional benefits if they replenish their investment portfolio with cash that equals the value of gifted stocks that have appreciated. This manner of reinvesting results in a cost-basis increase that enhances the potential for eventual **tax-loss harvesting**, which should help reduce future tax payments.

Let's examine a portfolio of, say \$1 million, with \$50,000 in securities to gift with a 100% appreciation level in a context similar to the previous example. In this case, however, we'll replenish the portfolio with cash. Given the size of the portfolio and the gift, the cash contribution raises the expected **tax alpha** by 5–10 basis points. The tax alpha, which is defined as the net after-tax excess return minus the gross pretax excess return, indicates how much better off the portfolio performs on an after-tax basis relative to the benchmark. Much of this performance increase comes from future tax-loss harvesting—meaning the incremental tax alpha comes from the expected additional tax losses that will be generated from reinvesting the added cash.

An added benefit of a cash replenishment after gifting securities is the portfolio manager can often reduce the tracking-error risk of the portfolio by targeting overweight names for gifting and reinvesting in other names, which lowers the overall **tracking error**.

The table below summarizes each charitable giving tax benefit method we've examined thus far.

Gift amount	Tax savings on current-year deduction	Capital gains tax avoided	Increased tax alpha
\$50k in cash	\$18.5k	NA	NA
\$50k in securities	\$18.5k	\$6k	NA
\$50k in securities plus cash replenishment	\$18.5k	\$6k	5–10 bps

The bottom line

Charitable giving is an important part of a wealth management strategy. There are many ways to provide gifts—straight cash, securities, and securities with cash replenishment. Cash gifts have the benefit of the current-year tax deduction. An appreciated stock gift has the added benefit of eliminating the capital gains tax that would have had to be paid. A gift of securities with cash replenishment gives the taxpayer the current-year tax deduction, avoidance of capital gains, and the potential for future tax-loss harvesting opportunities.

Determining the amount to give and the specific securities to gift can be challenging for many investors. The tax benefit depends on the appreciation level of the securities and the market value of securities selected for gifting.

Additionally, selecting the specific securities that provide the highest tax benefit while keeping the portfolio tracking the investor's selected index can be difficult. But choosing the right asset manager—one with expertise, tools, and reporting capabilities to help make the important decisions for your clients' portfolio needs—can make all the difference.

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Rey Santodomingo, CFA, Managing Director of Investment Strategy

Rey is responsible for all aspects of Parametric's tax-managed equity strategies. As one of the primary strategists for Custom Core®, he works closely with taxable clients and advisors to design, develop, and implement custom portfolio solutions. Prior to joining Parametric in 2008, Rey was a vice president in product management at MSCI Barra. He earned an MA in financial engineering from the University of California, Berkeley, and a BS in chemical engineering from the University of California, Santa Barbara. A CFA charterholder, Rey is a member of the CFA Society of Seattle and a prior board member of the CFA Society of Seattle. He has also served as an adjunct instructor at Seattle University's Albers School of Business and Economics.

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