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Three Wise Ways to Give Charitably

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As we move closer to the end of the year and head into the holiday season, now is an ideal time for charitable-minded investors to think not only about which causes and organizations are closest to their hearts but also about how to donate in a tax-efficient way. By giving more tax efficiently, investors can maximize their donations to charity while also reducing their tax burden.

With so many worthy causes, finding a charity and donating money to it seems simple. However, slightly different approaches to giving can yield dramatically different results. Let's look at the comparable after-tax benefits of three methods of charitable giving.

How much charitable giving is tax deductible?

After the temporary changes of the CARES Act in 2021, federal guidelines for charitable giving are back to normal this year. Charitable donations are deductible only for those taxpayers who itemize deductions. The amount of the deduction is limited to 60% of adjusted gross income (AGI) for cash donations and 30% of AGI for stock. Let's explore the tax impact of the three main types of charitable gifts.

Which method of charitable giving is best?

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 rate 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 × 37% = $18,500).

Gifting securities

Even in a down market, like 2022 has been so far, where the S&P 500® is down 17.7% through October, a client's portfolio value may be lower, but there may still be a lot of appreciation in the portfolio. 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. Donating the stock to charity is one way to completely avoid this liability. This enables investors to make their desired donation, deduct its value from their AGI, and sidestep the capital gains tax applied to stock sales.

To analyze the tax benefits of giving securities, 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 are held for at least one year and the dollar amount gifted is less than 30% of the investor's AGI.

The benefit of giving securities over cash is that the investor also avoids the tax liability embedded in the investment. In the example of 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. As with the cash gift, the taxpayer in this example also gets a same-year tax deduction of $50,000, which reduces their AGI.

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Gifting securities with cash replenishments

On top of the benefits of giving highly appreciated securities instead of cash, investors with a tax-managed direct indexing portfolio can realize additional benefits if they replenish their investment portfolio with cash that equals the value of gifted stocks. 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 $1 million, with $50,000 in securities to gift with a 100% appreciation level in a context like the previous example's. 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—defined as the net after-tax excess return minus the gross pretax excess return, which indicates how much the portfolio outperforms the benchmark on an after-tax basis. Much of this performance increase comes from future tax-loss harvesting, meaning the incremental tax alpha comes from the expected additional tax losses generated from reinvesting the added cash.

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

Clients can request a gifting analysis on their existing Custom Core® portfolios. Clients specify the amount of the gift and whether they'll be replenishing with cash, and Parametric runs an analysis providing a list of highly appreciated securities to gift. Parametric also takes into account the impact of tracking error on the portfolio from the gift. The advisor is responsible for initiating the transfer of securities. Once the transfer is complete, Parametric reconciles the account and may rebalance it if necessary.

The bottom line

Charitable giving is an important part of a wealth management strategy. Determining the amount and the specific financial instruments can be challenging for many investors. Selecting the path that provides the highest tax benefit while still aligning the portfolio with the investor's selected benchmark can be difficult. But choosing the right asset manager—one with the 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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Jeremy is responsible for 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 2012, Jeremy worked as an instructor in economics at the University of Washington and for Bernstein Investment Research and Management and Banc of America Investment Services. He earned MA and BS degrees in economics from the University of Washington.

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