Maximizing Tax Benefits Through Systematic Charitable Giving

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Charitable giving is an important part of a wealth management strategy. Whether giving cash, securities, or securities with cash replenishment, investors can also enjoy the benefit of tax deductions. Depending on how that gifting is structured, it can also reduce the investor's capital gains tax and increase the potential for tax-loss harvesting.

Key takeaways

- Charitable donations—deductible only for those taxpayers who itemize deductions—can play an important role in any investor's wealth management plan.
- A cash donation is deductible only from the current year's income taxes, while a donation of securities has the added benefit of avoiding taxes on capital gains.
- Investors can realize additional benefits if they replenish their investment portfolio with cash that equals the value of gifted stocks that have appreciated. Depending on how it's structured, a systematically recurring gift of securities that is then replenished can increase tax-loss harvesting opportunities dramatically.

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Making donations to a favorite charity is a common activity for many investors. While on its face this seems like a simple decision—find a charity, give it money—investors should consider this tax-beneficial process part of their overall wealth management plan. As with portfolio asset allocation and portfolio construction, there are nuances in the giving process where seemingly small changes can yield dramatic after-tax differences for the charity-minded investor. Let's look at the comparable after-tax benefits of giving cash, giving securities, and systematically 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.

First, charitable donations are deductible only for those taxpayers who itemize deductions. Since the 2017 Tax Cuts and Jobs Act increased the standard federal deduction, which currently stands at $12,950 for individuals and $25,900 for couples filing jointly, it has become more difficult for individuals to itemize their deductions. In our experience, most high-net-worth investors should have little difficulty clearing this hurdle. Second, the deduction is the same whether the donation is made in cash or stock. However, investors should keep in mind that they must hold that stock for more than a year before it's donated, and it's limited to 30% of the taxpayer's adjusted gross income (AGI).

Let's now look at the giving methods.

Giving cash

Cash is a convenient gift, because it's easy for donors to write checks and for charities to deposit them. 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).

Giving 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' after-tax return. Donating the stock to charity mitigates this liability. Doing so enables investors to make their desired donation, deduct its value from their AGI, and avoid the capital gains tax that would be due upon sale of the stock.

To analyze the tax benefits, 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% (or a cost basis of $25,000). Keep in mind the IRS only allows investors to take deductions from donated securities if the securities are held for at least one year, and the value of the gift is limited to 30% of the investor's AGI.

Whether cash or securities, donating either provides charitable organizations with the funds they need, but donating securities has the additional benefit of allowing investors to avoid the tax liability embedded in the investment. With the securities gift of $50,000 in this example, 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 can also sell the security tax free, making the gift as good as cash. As with the cash gift, the taxpayer in this example gets a current-year tax deduction of $50,000, which reduces their AGI.

Giving securities with cash replenishment

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 tax-loss harvesting, which can help reduce future tax payments.

FIGURE 1: CONCEPTUAL TAX BENEFITS FOR THREE METHODS OF CHARITABLE GIVING

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

Source: Parametric, 2022. For illustration purposes only.

Let's examine a portfolio that has been tax-managed for many years. It's worth $1 million and has $50,000 in low-cost securities to gift with a 100% appreciation level in a context similar to the previous example's. In this case, however, we'll replenish the portfolio with $50,000 in cash. Based on our simulations—and given the size of the portfolio and the gift—the cash contribution raises the expected tax alpha by five to 10 basis points. (See disclosures for information about how tax alpha is calculated.) Tax alpha is a measure of 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 generated by the cash contribution.

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

Systematic charitable giving

The methods of charitable giving we examine in figure 1 apply to investors who make a one-time gift. We'll now consider the after-tax effects of systematic charitable gifts with cash replenishment on a recurring basis over a 10-year period. Implementing a systematic giving plan with cash replenishment in a tax-managed index-based portfolio introduces an even higher level of after-tax benefits. To determine just how high, we backtested a number of scenarios, varying the amount and recurrence of the gift. Figure 2 shows the results.

Figure 2 shows that the base-case tax alpha is 0.3% net of fees, which was measured for a portfolio with no giving and no cash contributions over the bull market from July 2012 to June 2022. For a 5% annual gift with cash replenishment, the tax alpha increases from 0.3% to 0.5%. The additional tax alpha comes from the increased potential for tax-loss harvesting resulting from the cash contribution. If we double the gift to 10% annually, the tax alpha more than doubles from the base case to 0.8%. Finally, if we increase the gift to 5% quarterly (roughly 20% each year), the tax alpha increases to 1% annualized tax alpha, an improvement of more than three times the base case. Figure 3 shows the total amount of the tax deduction and the gains avoided over the 10-year period.

In addition to increased tax alpha, systematic giving results in the same tax deduction and capital gains avoidance we observed in the one-time gift in figure 1. For the systematic giving case, in which 5% of the portfolio was gifted annually and replenished with cash, the resulting 10-year gift was roughly $961,000. If we apply the maximum federal income tax rate of 37%, this gift results in an estimated $356,000 income tax savings due to the tax deduction.

FIGURE 2: CONCEPTUAL SCENARIOS OF TAX-MANAGED SYSTEMATIC GIVING (HYPOTHETICAL)

			Gifting (with cash replacement)		
	Benchmark	Base case	5% annually	10% annually	5% quarterly
Pretax return (%)	13.0	12.9	12.9	12.8	12.8
After-tax return (%)	12.1	12.8	13.0	13.2	13.4
Pretax excess return (%)	-	-0.1	0.0	-0.1	-0.1
After-tax excess return (%)	-	0.7	0.9	1.1	1.3
Tracking error (%)	-	0.4	0.4	0.4	0.5
Gross tax alpha (%)	-	0.7	0.9	1.2	1.4
Net tax alpha (%)	-	**0.3**	**0.5**	**0.8**	**1.0**

Source: Parametric, June 2022. Simulated performance is hypothetical and provided for illustrative purposes. Simulated performance does not reflect the projected performance of any investment strategy offered by Parametric. Simulations are based on a US Large Cap tax-managed index portfolio starting with $1 million in market value benchmarked against the S&P 500® Index. Backtest period is July 2012 through June 2022. All returns presented are net of transaction costs of 10 bps per 100% turnover. Net-of-fee tax alpha is net of a 35 bps annual management fee deducted every month.

Furthermore, the capital gains avoided through this series of giving was about $529,000. Assuming a federal capital gains tax rate of 20% and the applicable 3.8% Medicare surtax, this gain avoidance is worth a little over $126,000. Overall, the systematic giving resulted in tax savings of more than $482,000 from total gifts of roughly $961,000. However, we see the highest tax benefit from the 5% quarterly gift, where the value of the tax deduction and the capital gains tax avoided result in a tax savings of $1.43 million.

Conclusion

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 and market value of securities selected for giving. In addition, selecting the specific securities that provide the highest tax benefit while balancing tracking error versus 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. Parametric provides a unique charitable giving analysis that identifies the tax lots to gift, quantifies the value of the tax deduction and the capital gains tax avoided, and reports estimated tax alpha increases.

Charitable giving is an important part of a wealth management strategy. There are many ways to provide gifts—whether straight cash, securities, or securities with cash replenishment. Cash gifts have the benefit of the current-year tax deduction. An appreciated stock gift has the added benefit of reducing the investor's capital gains tax. 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.

FIGURE 3: CONCEPTUAL TAX DEDUCTION WITH AVOIDED GAINS AMOUNT OVER 10 YEARS (HYPOTHETICAL)

	Gifting (with cash replacement)		
	5% annually	10% annually	5% quarterly
Gift amount	$961k	$1,919k	$3,002k
Capital gains avoided	$529k	$938k	$1,327k
Value of tax deduction	$356k	$710k	$1,111k
Value of capital gains tax avoided	$126k	$223k	$316k
Total tax value of systematic giving	**$482k**	**$933k**	**$1.43MM**

Source: Parametric, June 2022. Simulated performance is hypothetical and provided for illustrative purposes. Simulated performance does not reflect the projected performance of any investment strategy offered by Parametric. Simulations are based on a US Large Cap tax-managed index portfolio starting with $1 million in market value benchmarked against the S&P 500® Index. Backtest period is July 2012 through June 2022. All returns presented are net of transaction costs at 10 bps per 100% turnover. Net-of-fee tax alpha is net of a 35 bps annual management fee deducted every month.

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Tax alpha measures the impact of tax management on client accounts compared with the tax consequences of simply replicating the benchmark without regard to taxes. Tax alpha's main components are the before- and after-tax performance of client accounts and the benchmark. For client accounts, after-tax performance is based on actual realized gains and losses. For the benchmark, after-tax performance is based on the gains and losses the benchmark would have incurred due to index turnover and client-directed activity (such as withdrawals). The gross-of-fees (GoF) formula for calculating tax alpha is *Tax AlphaGoF=AfterTax Excess ReturnGoF-BeforeTax Excess ReturnGoF*. The net-of-fees (NoF) formula is *Tax AlphaNoF=AfterTax Excess ReturnNoF-BeforeTax Excess ReturnGoF*.

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