aperio
by BlackRock

Charitable Donation Analysis

Challenge

Philanthropic individuals can make charitable contributions to the causes close to their hearts—and receive a tax deduction while reducing their long-term tax liability—by donating appreciated assets instead of cash. But identifying the best assets to use requires assessing each tax lot. Aperio conducts charitable donation analyses to recommend shares that optimize your clients' situations.

Solution

The tax code offers tax benefits for donating securities with unrealized gains, allowing donors to itemize the full market value as deductions on Schedule A of Form 1040[1] while avoiding taxes on these capital gains.[2]

Our process

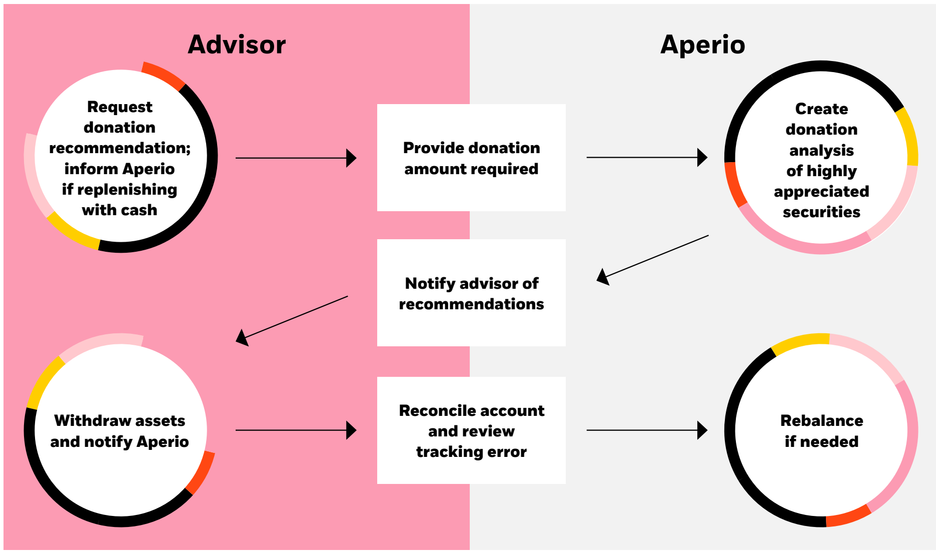
Aperio collaborates with your team to identify the ideal securities that maximize tax benefits while maintaining desired portfolio characteristics (e.g., tracking error).

We typically turn around the analysis within 48 hours, but during December, the turnaround time extends to 72 hours.

Below, we review the two primary approaches to optimal charitable donation:

1. Donate securities and replenish portfolio with cash
2. Donate securities without cash replenishment

For illustrative purposes only. Process subject to change.



Case study: Donate and replenish with cash

A hypothetical client sets aside $100,000 to donate to charity. Instead of donating $100,000 in cash, her advisor recommends gifting the same amount in appreciated securities identified by Aperio from her portfolio and replenishing her portfolio with the $100,000 in cash. Aperio invests the cash to maintain or improve tracking error while creating the potential for better tax-loss harvesting in the future. To identify the optimal securities to donate, Aperio sorts her portfolio's tax lots by percentage gain as shown in the table below. After testing pathways to improve tracking error with similar unrealized gains, Aperio recommends specific tax lots to donate.[3]

Sample total market value: $101,480.76
Sample gain amount: $86,888.07

Sample total request amount: $100,000

Sample security description	Ticker	Purchase date	Total cost basis	Shares to transfer	Position value	Gain amount	Gain percent	Gain/value ratio
Ovintiv Inc	OVV	3/16/2020	$125.07	44.00	$2,260.72	$2,135.65	1,708%	94%
Tesla Inc	TSLA	6/11/2019	$647.09	45.00	$10,494.90	$9,847.81	1,522%	94%
Devon Energy Corp	DVN	4/3/2020	$837.54	122.00	$9,498.92	$8,661.38	1,034%	91%
Cenovus Energy Inc	CVE	4/3/2020	$1,602.05	681.00	$14,018.73	$12,416.67	775%	89%
Nvidia Corp	NVDA	10/18/2016	$1,018.79	61.00	$8,412.51	$7,393.72	726%	88%
Coterra Energy Inc	CTRA	3/16/2020	$441.92	112.00	$3,509.52	$3,067.60	694%	87%
EQT Corp	EQT	2/13/2020	$505.23	93.00	$3,814.40	$3,309.16	655%	87%
Apple Inc	AAPL	1/5/2017	$5,126.44	176.00	$26,956.37	$21,829.93	426%	81%
Apple Inc	AAPL	1/5/2017	$4,288.55	147.00	$22,514.70	$18,226.15	425%	81%

This analysis is provided for illustrative purposes only and should not be considered representative of an actual portfolio.
Actual portfolios will differ in their holdings, purchase dates, cost bases, shares held, stock prices, unrealized gains, and gifting levels.

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We believe that donating securities and replenishing the portfolio with cash may be among the most tax-efficient strategies that do not generally adversely impact portfolio characteristics. Moreover, this approach may increase the loss-harvesting potential of an otherwise highly appreciated portfolio.

Case study: Donate without cash replenishment

A hypothetical client wants to make a $100,000 donation from his Aperio portfolio, which has a tracking error of 0.77%. The client seeks to gift highly appreciated securities without meaningfully increasing his portfolio's tracking error. Less-than-maximum unrealized gains are acceptable; he does not want to take a pro rata approach. Aperio analyzes the client's portfolio and finds that maximizing unrealized gains would significantly increase tracking error. Alternatively, Aperio suggests a solution where unrealized gains remain substantial with only a minor increase in tracking error. **Donating securities and not replenishing the portfolio with cash may require a trade-off between the amount of unrealized gains and tracking error.**

	Maximum unrealized gains	Optimized solution	Pro rata approach
Sample target donation	$100,000	$100,000	$100,000
Sample unrealized gains	$70,913	$67,548	$43,114
Sample tracking error (Aperio)	1.04%	0.79%	0.77%

Benefits

The tax code offers tax benefits for gifting securities with unrealized gains to applicable charitable entities.

The benefits are twofold:

1. Donors can itemize the market value of donated long-term[4] securities to a charity or donor-advised fund (DAF) as deductions on Schedule A, and thus reduce their income tax
2. The future tax liability on the unrealized capital gains is eliminated

Costs/limitations

The tax deductibility of charitable donations of long-term appreciated stock is limited by the tax code to 30% of adjusted gross income (AGI) for public charities and 20% of AGI for certain private charities.[5]

For illustrative purposes only.

[1] Conditions apply.

[2] For short-term holdings, only the value of the cost basis is deductible.

[3] The table on page 1 is shown for illustrative purposes only and should not be construed as being representative of any individual's actual situation. Please see commentary below for key assumptions around our tax-loss harvesting process.

[4] For short-term holdings, only the value of the cost basis is deductible.

[5] IRS Publication on Charitable Contributions: www.irs.gov/publications/p526.

Important notes

The information is provided with the understanding that we do not guarantee its accuracy, and are not engaged in rendering legal, accounting, or tax services. We recommend that all investors seek out the services of competent professionals in these areas. The strategies and/or investments referenced may not be suitable for all investors because the appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. None of the examples should be considered advice tailored to the needs of any specific investor or a recommendation to buy or sell any securities.

Investing involves risk, including possible loss of principal. Asset allocation and diversification may not protect against market risk, loss of principal, or volatility of returns. There is no guarantee that any investment strategy discussed herein will work under all market conditions.

You should not assume that investment decisions we make in the future will be profitable or will equal the investment performance of the past. With respect to the description of any investment strategies, simulations, or investment recommendations, we cannot provide any assurances that they will perform as expected and as described in our materials. Past performance is not indicative of future results.

Due to the complexity of tax law, not every single taxpayer will face the situations described herein exactly as calculated or stated; i.e., the examples and calculations are intended to be representative of some but not all taxpayers. Since each investor's situation may be different in terms of income tax, estate tax, and asset allocation, there may be situations in which the recommendations would not apply. Please discuss any individual situation with tax and investment advisors first before proceeding. Taxpayers paying lower tax rates than those assumed or without taxable income would earn smaller tax benefits from tax-advantaged indexing or even none at all compared to those described.

The optimization process Aperio uses in tax-loss harvesting and generating sample portfolios relies upon optimization software developed by MSCI. The software utilizes a mathematical objective function that seeks to minimize the combination of active risk (i.e., forecast tracking error) and, when applicable, the tax liability on realized gains, while also meeting the conditions presented by a series of simultaneous equations, the values of which are, in part, populated by data based upon the securities being analyzed. With respect to measuring potential equity risk in the process of tax-loss harvesting and portfolio analysis, Aperio also uses and relies upon MSCI Barra risk models. You should note that such use and reliance of the MSCI Barra risk models in the optimization and equity risk analysis presents model risk, which is defined as the potential for adverse consequences from decisions based on incorrect or misused model outputs and reports. Model risk can lead to financial loss.

The mathematical calculation and quantification exercise underlying any model generally involves application of theory, choice of sample design and numerical routines, selection of inputs and estimation, and implementation in information systems. Errors can occur at any point from design through implementation. In addition, shortcuts, simplifications, or approximations used to manage complicated problems could compromise the integrity and reliability of outputs from those calculations. Finally, the quality of model outputs depends on the quality of input data and assumptions, and errors in inputs or incorrect assumptions will lead to inaccurate outputs. The model may be used incorrectly or inappropriately. Even a fundamentally sound model producing accurate outputs consistent with the design objective of the model may exhibit high model risk if it is misapplied or misused. Models by their nature are simplifications of reality, and real-world events may prove those simplifications inappropriate.

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