

## 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 Internal Revenue Service (IRS) 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.<sup>1</sup> The IRS waives taxes on all capital gains subject to income requirements.<sup>2</sup> **Thus, donating the most appreciated securities may create the greatest reduction in future tax liability.**

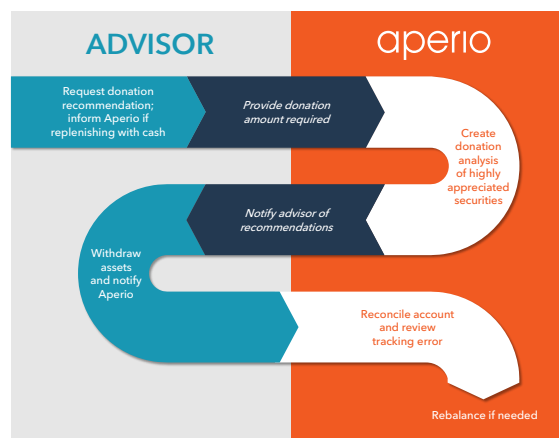
## OUR PROCESS

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

The analysis is typically turned around 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



## CASE STUDY: DONATE AND REPLENISH WITH CASH

A client sets aside \$350,000 to donate to charity. Instead of donating \$350,000 in cash, her advisor recommends gifting the same amount in appreciated securities identified by Aperio from her portfolio and replenishing her portfolio with the \$350,000 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.<sup>3</sup>

Total Request Amount: \$350,000					Total Market Value		\$ 350,365.55	
					Gain Amount		\$ 325,198.03	
Security Description	Ticker	Purchase Date	Total Cost Basis	Shares to Transfer	Position Value	Gain Amount	Gain Percent	Gain / Value Ratio
PAYPAL HOLDINGS INC	PYPL	12/12/2008	\$230.40	27	\$4,884.57	\$4,654.17	1920%	95%
PAYPAL HOLDINGS INC	PYPL	4/15/2009	\$332.40	38	\$6,874.58	\$6,542.18	1868%	95%
ADOBE INC	ADBE	4/15/2009	\$560.15	24	\$11,424.00	\$10,863.85	1839%	95%
EQUINIX INC	EQIX	12/12/2008	\$1,706.89	35	\$26,856.90	\$25,150.01	1373%	94%
VERISIGN INC	VRSN	1/14/2009	\$274.81	20	\$4,059.80	\$3,784.99	1277%	93%
LAM RESEARCH CORP	LRCX	12/12/2008	\$782.40	36	\$11,037.60	\$10,255.20	1211%	93%
MICROSOFT CORP	MSFT	3/9/2009	\$18,200.34	1,190	\$244,009.50	\$225,809.16	1141%	93%
THERMO FISHER SCIENTIFIC INC	TMO	3/9/2009	\$3,080.14	95	\$41,218.60	\$38,138.46	1138%	93%

*This analysis is provided as an example 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.*

<sup>1</sup> Conditions apply.

<sup>2</sup> For short-term holdings, only the value of the cost basis is deductible.

<sup>3</sup> The table shown below is for illustrative purposes only and should not be construed as being representative of any individual's actual situation. Please see end notes for key assumptions around our tax-loss harvesting process.

*We believe that donating securities and replenishing the portfolio with cash may be among the most tax-efficient strategies that do not 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 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.

	Maximum Unrealized Gains	Optimized Solution	Pro-Rata Approach
Target Donation	\$100,000	\$100,000	\$100,000
Unrealized Gains	\$70,913	\$67,548	\$43,114
Tracking Error (Aperio)	1.04%	0.79%	0.77%

*Donating securities and not replenishing the portfolio with cash may require a trade-off between the amount of unrealized gains and tracking error.*

## BENEFITS

The IRS 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<sup>4</sup> securities to a charity or donor-advised fund (DAF) as deductions on Schedule A, and thus reduce their income tax
- (2) The tax liability on the unrealized capital gains is eliminated

## COSTS/LIMITATIONS

- The tax deductibility of charitable donations is limited by the IRS to 30% of adjusted gross income (AGI) for public charities and 20% of AGI for certain private charities<sup>5</sup>
- For tax year 2020, the CARES Act changes the AGI limit for cash donations<sup>6</sup>
- Please consult your tax professional for more information on income limitations and the CARES Act

*Related resource:* [Case Study – Charitable Donations](#)

The information contained within this presentation was carefully compiled from sources Aperio believes to be reliable, but we cannot guarantee accuracy. We provide this information with the understanding that we are not engaged in rendering legal, accounting, or tax services. In particular, none of the examples should be considered advice tailored to the needs of any specific investor. We recommend that all investors seek out the services of competent professionals in any of the aforementioned areas.

The optimization process used in tax-loss harvesting by Aperio relies upon an optimization model built and designed by MSCI Barra. The model utilizes a mathematical objective function that seeks to minimize the combination of active risk (i.e., forecast tracking error) and the tax liability on realized gains, all 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 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.

<sup>4</sup> For short-term holdings, only the value of the cost basis is deductible.

<sup>5</sup> IRS Publication on Charitable Contributions: [www.irs.gov/publications/p526](http://www.irs.gov/publications/p526).

<sup>6</sup> The CARES Act: [www.congress.gov/bill/116th-congress/senate-bill/3548](http://www.congress.gov/bill/116th-congress/senate-bill/3548).