Implementing SRI/ESG Values More Tax Efficiently Using Charitable Donations

aperio

Taxable investors seeking to incorporate socially responsible investing/environmental, social, and governance (SRI/ESG) values into their accounts may be able to avoid realizing gains on SRI exclusions through charitable donation and cash replenishment.

INVESTMENT PROBLEM

When a client wants to transition a low-basis portfolio to an index-tracking portfolio that reflects a set of SRI/ESG values, the transition may require the selling of stocks with gains, and the tax impact of these gains may be prohibitive.

Aperio Group has developed an approach whereby we can work with a client who has a **budget** for a **charitable donation** with **cash replenishment** to reduce the tax impact of the transition.

CHARITABLE DONATION WITH CASH REPLENISHMENT

When a client is a making a charitable donation with cash replenishment, Aperio's standard recommendation is to donate the most highly appreciated shares because the cash replenishment leads to the same or lower forecast tracking error.[1]

However, when a client is seeking to transition an account, Aperio can identify shares to donate that would have to be sold as part of the transition. Note that this approach does not maximize the reduction in *unrealized* tax liability; instead, it optimizes the reduction in the *realized* taxes resulting from the transition.

APERIO'S APPROACH

Aperio's approach to each client's unique situation typically involves crafting a plan that involves iterative steps to identify stocks the optimizer would want to sell—then flagging them for donation:

1. **First step:** Flag stocks that would be sold due to SRI exclusions.
2. **Second step:** Then, also flag stocks that would be sold due to SRI tilts/scoring.
3. **Third step:** Then, also flag stocks that would be sold to lower forecast tracking error.

> **Background on Index-Tracking Portfolios**
>
> Index-tracking portfolios use an optimizer to construct portfolios and buy/sell trade lists.
>
> In this case study, there are three reasons why an optimizer would sell shares at a gain:
>
> a. To achieve SRI exclusions
> b. To achieve SRI tilts/scoring
> c. To lower the forecast tracking error

Based on which stocks are flagged and the corresponding estimated tax cost for the transition, Aperio provides the client a list of shares for donation. After the client donates the shares and replenishes the donated value with cash, Aperio can execute the transition.

HYPOTHETICAL EXAMPLE: BACKGROUND

As an example, consider a hypothetical client who wants to transition a low-basis portfolio to an index-tracking Low-Carbon SRI portfolio, with additional details in the box below.

Transitioning such a hypothetical portfolio to such an index-tracking Low-Carbon SRI portfolio would require the removal of 50 stocks from the original portfolio, with unrealized net gains of $1.5 million ($557,000 in taxes). SRI tilts/scoring would require removal of additional stocks with potential additional unrealized gains. Meanwhile, the hypothetical client wants to pay less than $10,000 in taxes.

Hypothetical Low-Basis Portfolio	
Market Value (MV)	$28M
Cost Basis	$7M
Unrealized Gains	$21M
Cost Basis to MV	**25%**

However, the hypothetical client has indicated it has a $4 million **budget** for a **charitable donation** with **cash replenishment**.

The budget can be used for appreciated shares that would be sold during the transition due to: SRI exclusions, SRI tilts/scoring, and/or lowering the portfolio's forecast tracking error. The remaining budget can be used for the most highly appreciated shares.

Aperio v. [Latin] to make clear, to reveal the truth

HYPOTHETICAL EXAMPLE: STEPS TAKEN & RESULTS

Aperio would work with the hypothetical client and craft a plan involving iterative steps to identify stocks the optimizer would want to sell–then flag them for donation:[2]

The steps in this plan would identify shares for donation as follows (with the 10 most highly appreciated donated stocks shown below):

- Flagged stocks with gain to market value > 20%
- Non-flagged stocks with gain to market value > 96.65 %

Charitable Donations:
10 Most Highly Appreciated Stocks

						3,281,026	718,974	4,000,000	1,097,307	12,761	4,734
					FLAGS	LOTS for DONATION		Total MV	Total Cost	Cap Gains	Taxes
						FLAG with Gain/Market Value >	Other with Gain/Market Value >			Non-Donated Flagged Stocks That Would	Non-Donated Flagged Stocks That Would
Security	Market Value	Gain/Loss	Gain/ Market Value	Percent Appreci-ation	SRI	20.0%	96.65%			Have to be Sold	Have to be Sold
Company A	16,425	16,385	99.8%	41169%		0	16,425	16,425	40	0	0
Company B	326,778	320,808	98.2%	5374%		0	326,778	326,778	5,970	0	0
Company C	48,454	46,871	96.7%	2962%		0	48,454	48,454	1,582	0	0
Company D	452,206	437,313	96.7%	2936%		0	292,397	292,397	9,630	0	0
Company E	157,971	152,755	96.7%	2928%		0	34,920	34,920	1,153	0	0
Company F	191,823	173,334	90.4%	937%	1	191,823	0	191,823	18,489	0	0
Company G	6,429	5,718	88.9%	804%	1	6,429	0	6,429	711	0	0
Company H	6,393	5,642	88.3%	751%	1	6,393	0	6,393	751	0	0
Company I	11,521	10,097	87.6%	709%	1	11,521	0	11,521	1,424	0	0
Company J	85,965	75,220	87.5%	700%	1	85,965	0	85,965	10,745	0	0

Data is provided for illustration purposes only; it is not a recommendation to buy or sell any security, make any investment decision, or adopt any investment strategy.

After donating the flagged stocks and replenishing with cash, the realized gains would be less than $13,000, and the tax cost would be less than $5,000–well within the tax budget for the hypothetical client.

Endnotes

[1] If the donated shares were then bought back, the forecast tracking error would be unchanged.
[2] For each optimization run, any remaining budget would be applied to the most highly appreciated remaining tax lots.

Disclosures

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 hypothetical tax costs shown in the hypothetical transition are subject to the limitations of the underlying optimization model and specific calculation methodology applied. Actual tax costs of transitions may vary and could be materially lower than reflected above due to many factors, including an investor's particular tax circumstances that could lead to results differing from the hypothetical example presented. The calculations used in preparing the information above assume specific tax rates of 54.1% (short-term) and 37.1% (long-term), reflecting the highest tax rates of a California resident on the date of this study. Future changes in tax policy and rates are to be expected and may impact the hypothetical transition. Individual results will vary.

The optimization process used in the hypothetical example presented 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.

The model used in preparing the hypothetical results may have fundamental errors and may produce inaccurate outputs when viewed against the design objective and intended business uses. 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.

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. Every investment program has the potential for loss as well as gain.