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What's the Best Way to Maximize the Tax Benefits of Charitable Giving?

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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?

As an extension of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, taxpayers not itemizing deductions may deduct $300 for individuals and $600 for joint filers on top of the standard deduction for the 2021 tax year. Outside of that additional deduction in 2021, charitable donations are deductible only for those taxpayers who itemize deductions. Normally, the amount of the deduction is limited to 60% of adjusted gross income (AGI) for cash donations and 30% of AGI for stock. However, as a part of the CARES Act, the deduction for cash donations is up to 100% of AGI.

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 x 37% = $18,500).

Gifting securities

So far this year, through the end of October, the S&P 500® Index is up just over 24% and is up almost 43% over the past 12 months. 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. A way to completely avoid this liability is by donating the stock to charity. This enables investors to make their desired donation, deducts its value from their AGI, and sidesteps the capital gains tax that gets 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 that the IRS allows investors to take deductions from donated securities only if the securities were 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 with 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. Similar to 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 direct indexing portfolio of $1 million, with $50,000 in securities to gift with a 100% appreciation level in a context similar to the previous example. 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 better off the portfolio performs on an after-tax basis relative to the benchmark—by five to 10 basis points. Much of this performance increase comes from future tax-loss harvesting, meaning the incremental tax alpha comes from the expected additional tax losses that will be 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.

Charitable giving methods by the numbers

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

For illustrative purposes only.

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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