



RESEARCH INSIGHTS REPORT

Smart Giving

Maximizing your charitable dollars through donations of appreciated stocks and mutual funds

INTRODUCTION

For most Americans charitable giving is an essential part of their lives. Eighty-three percent of Americans give annually to charity¹ and such giving is a significant part of annual spending at all income levels. The vast majority of all charitable giving comes in the form of cash, especially for the 99% of all households who earn less than \$500,000 a year. Internal Revenue Service data for the year 2004 show that individuals who itemized their deductions made charitable donations of \$166 billion, with \$123 billion being cash and \$43 billion being non-cash gifts.² Non-cash gifts can include toys, clothes, and even real estate, as well as stocks, mutual funds, and other securities.

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Breakdown of Cash versus Non-Cash Gifts to Charity by Income Level

Adjusted Gross Income	Average gifts by adjusted gross income level			
	Average Total Gifts	Average Total Cash Gifts	Average Total Non-Cash Gifts	Percentage Non-Cash Gifts
Under \$60K	\$2,128	\$1,737	\$391	18%
\$60K – \$75K	\$2,672	\$2,209	\$462	17%
\$75K – \$100K	\$2,804	\$2,257	\$547	20%
\$100K – \$200K	\$4,110	\$3,301	\$809	20%
\$200K – \$500K	\$8,720	\$6,766	\$1,954	22%
\$500K – \$1 MIL	\$22,104	\$15,776	\$6,327	29%
\$1 MIL – \$5 MIL	\$75,490	\$41,821	\$33,669	45%

Giving amounts based on 2004 IRS tax return data. Data obtained from <http://www.irs.gov/pub/irs-soi/04in21id.xls>.

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SINCE THE SECURITIES ARE DONATED RATHER THAN SOLD, CAPITAL GAINS TAXES WHICH WOULD HAVE BEEN TRIGGERED BY THE DONOR'S SALE OF THE APPRECIATED SECURITIES ARE AVOIDED

For individuals who itemize deductions, clearly, the lion's share of all giving comes in the form of cash, but it is equally clear that as income levels increase, the percentage of non-cash donations, including appreciated securities, rises as well. There are a number of reasons for this. First, more affluent households have a higher likelihood of owning securities investments and of working with a financial advisor/financial planner. According to Cerulli Associates, 51% of financial advisors provide charitable planning advice,³ which may include advice on donating appreciated securities. Second, with greater income levels, the sheer scale of donated assets increases so that potential giving amounts of appreciated securities pass the minimum levels that many charities set for accepting them.

While cash donations are certainly desired by charities and provide a tax deduction for the donor, a more tax-efficient way of giving is sometimes possible: donating securities with long-term appreciation. In fact, Fidelity estimates that the additional annual federal tax savings for Americans who could donate appreciated securities instead of cash is between \$2.2 billion and \$4.5 billion.⁴ Simply put, millions of Americans who itemize their charitable deductions could potentially save billions of dollars or give billions more a year to charity if they understood the tax advantages of using appreciated securities they already own — whether they be stocks, bonds or mutual funds — instead of cash to make gifts they already intend to make.⁵

Here's the key advantage in a nutshell. Almost any appreciated securities with long-term unrealized gains (meaning it was purchased over a year ago and has a current value greater than its cost basis)⁶ may be donated to an IRS-qualified public charity or to a qualified public charity with a donor advised fund program and an itemized federal income tax deduction taken for the full market value of the securities — up to a limit of 30% of the donor's adjusted gross annual income (AGI).⁷ Since the securities are donated rather than sold, capital gains taxes that would have been triggered by the donor's sale of the appreciated securities are avoided — and, if the donor chooses, the security position can be immediately recreated with cash by repurchasing the securities in the market. Though there may be some transaction fees for repurchasing the securities (often not with mutual funds), the cost basis is essentially raised by the amount of unrealized gain in the original securities.

Let's look at an illustrative example: Suppose someone wants to donate \$10,000 to a charity and is considering whether to donate \$10,000 in securities with a long-term gain of \$6,000 (cost basis of \$4,000) or \$10,000 in cash. We'll assume the \$10,000 donation to charity fits within the 30% ceiling on their AGI.

Assuming a 28% personal federal income tax rate, donating the cash or securities would yield the same potential itemized tax deduction of \$10,000 resulting in a tax savings of \$2,800. But giving the appreciated securities has an additional advantage of avoiding the capital gains tax on \$6,000 worth of gain when the securities are eventually sold. After donating the securities to charity, the individual could then simply take the remaining \$10,000 in cash and repurchase the securities.⁸ The repurchased securities would then have a cost basis of \$10,000. Assuming that long-term capital gains taxes are 15%, raising the basis from \$4,000 to \$10,000 has a real, after-tax economic value of \$900 (15% * \$6,000) — over and above the initial savings on personal income taxes. By choosing to use appreciated securities instead of cash, the donor emerges significantly better off financially. Details are provided in the table below.

Donating Long-Term Appreciated Securities versus Giving Cash

HYPOTHETICAL EXAMPLES: Starting assets of \$20,000 — including \$10,000 in securities (with long-term appreciation and a basis of \$4,000) and \$10,000 in cash		
	EXAMPLE 1 Donate the Appreciated Securities and Keep the Cash	EXAMPLE 2 Donate the Cash and Keep the Appreciated Securities
Amount of donation	\$10,000	\$10,000
Cost basis of donation	\$4,000	\$10,000
Federal ordinary income tax rate	28%	28%
Federal tax savings from itemized deduction of donation	\$2,800	\$2,800
Remaining assets	\$10,000 in cash	\$10,000 in securities with \$4,000 cost basis
Repurchase of securities	\$10,000 (transaction costs ignored)	N/A
Federal long-term capital gains tax rate	15%	15%
Federal tax if securities are liquidated	\$0 (\$10,000 – \$10,000)	\$10,000 market value – \$4,000 basis = \$6,000 gain \$6,000 gain * 15% tax rate = \$900
Liquidation value of remaining assets	\$10,000	\$9,100
Potential federal tax savings from avoiding capital gains	\$900	\$0

Note again that the tax-savings potential from using long-term appreciated securities to give to charity is **over and above** the tax savings from making a cash donation. So if making a cash donation would save \$2,800 in federal income taxes and giving appreciated securities would save \$900 in capital gains taxes, the total federal long-term tax savings would be \$3,700. For any given individual, the potential tax savings naturally depend on the amount of securities in their portfolio and the amount of long-term unrealized gains latent in those holdings. The greater the unrealized gain as a percentage of the securities' market value, the greater the opportunity to avoid capital gains taxes by donating the securities.

PART 1

CALCULATING TAX SAVINGS WHEN DONATING APPRECIATED SECURITIES

We quantify the tax-savings opportunity of donating appreciated securities by using a simple ratio: the cost basis of the security as a percentage of the current market value of the security. This ratio is called the basis-to-value ratio or BVR.

Clearly, the most tax-effective securities to donate are those with the largest unrealized gain on a percentage basis, or lowest BVR. In examining which securities to donate, the BVR of each tax lot should be calculated and all the tax lots should be ranked from lowest to highest. A tax lot is a specific asset purchased at a specific date and time (e.g., 100 shares of XYZ Corp. purchased for \$38.51 per share on July 20, 2003). The total shares a person owns of any one security may consist of any number of tax lots (individual purchases). It is important to calculate the BVR of each tax lot of a security since some lots in the overall holding may have been bought far below current market value (and have very low BVRs) while others



The most **tax-effective** securities to donate are those with the lowest basis to value ratio

may have been bought at prices close to or even above the security's current price. Using average cost basis on the entire security is permitted but that risks mixing up high BVR tax lots with low BVR tax lots and some or all of the tax-savings opportunity would be lost. It generally makes more economic sense to select individual tax lots to donate rather than automatically donate an entire security. Whenever possible, specific share cost basis should be used, rather than average cost basis, as it will give greater control over the tax savings that can be realized.⁹

The securities (tax lots) to donate to charity are those with unrealized long-term gain. In general, tax lots that have unrealized short-term gains should not be used for charitable giving¹⁰ because these gains are not eligible for any tax deduction (only the basis is tax-deductible). In general, only when (or if) these lots change from short-term gain lots to long-term gain lots after being held for over one year should they be considered for charitable giving, though there are a few exceptions so it makes sense to check with a tax advisor.¹¹ Similarly, it is tax inefficient to use tax lots of securities with unrealized losses (whether short-term or long-term) for charitable giving. Doing so simply forfeits a potential tax loss — and tax savings — for the donor, without the charity being able to take advantage of that loss. A better tactic would be for the donor to sell lots with unrealized losses, harvest those losses for tax savings, and donate the realized cash.¹² In this case, lots with the highest BVR should be sold to maximize the tax value of the loss.

(As an aside, tax-loss harvesting should be considered periodically anyway, at least once a year, regardless of any charitable giving. See Fidelity's Insight Report "Are You Missing Out on Lower Tax Bills?" for more information on tax-loss harvesting.)

Selecting appreciated securities to donate is a straightforward process: simply rank the lots with long-term unrealized gains from lowest BVR to highest BVR and allocate each lot to fund the giving amount until either the giving amount is achieved or no long-term unrealized gain lots remain. To reach the desired giving amount exactly, the last lot used may need to be split, with part being donated and part being kept in the portfolio. As each lot is added to the giving amount, add up the basis as well as the market value.

Through this approach, a total BVR for the donation may be calculated and thus the potential federal long-term capital gains tax savings (in addition to the value of the itemized deduction) may be calculated fairly straightforwardly. Assuming a 15% federal long-term capital gains tax rate, the federal capital gain tax savings is (the market value of the appreciated securities donated – the cost basis of the appreciated securities) * 15%. For example, suppose \$15,000 is donated consisting of \$4,000 in cash and \$11,000 in appreciated securities with a cost basis of \$6,000. The federal tax savings (over and above the federal income tax savings from making the donation) would be $(\$11,000 - \$6,000) * 15\% = \$750$.

A couple of examples will help illustrate the process:

EXAMPLE 1: Desired giving amount of \$10,000

Lot	Description	Market Value	Basis	BVR
Lot 1	100 shares of XYX Corp.	\$3,600	\$1,800	50%
Lot 2	50 shares of ABC Mutual Fund	\$1,000	\$600	60%
Lot 3	100 shares of XYX Corp.	\$4,000	\$3,000	75%
Lot 4	200 shares of Alpha Corp.	\$10,000	\$8,000	80%
Lot 5	50 shares of Beta Corp.	\$2,000	\$1,800	90%
Lot 6	150 shares of Theta Corp.	\$3,000	\$2,850	95%

Giving amount from appreciated securities = \$10,000, so no additional cash is needed. Only the lowest BVR securities — those with the highest unrealized gains — are donated. Lots 1 through 3 would be donated in their entirety and only part of Lot 4 (\$1,400 out of \$10,000) would need to be donated to meet the desired giving amount. None of Lot 5 or 6 would be needed. The cost basis of the securities given is \$1,800 + \$600 + \$3,000 + (\$1,400 * BVR of 80% for Lot 4) = \$6,520. Assuming a 15% long-term capital gains tax rate, the tax savings is $(\$10,000 - \$6,520) * 15\% = \$522$.

EXAMPLE 2: Desired giving amount of \$10,000

Lot	Description	Market Value	Basis	BVR
Lot 1	20 shares of XYX Corp.	\$3,400	\$850	25%
Lot 2	50 shares of XYX Corp.	\$2,200	\$1,100	50%
Lot 3	50 shares of Theta Corp.	\$1,800	\$1,440	80%
Lot 4	20 shares of Alpha Corp.	\$1,000	\$900	90%

Giving amount from securities = \$8,400 so \$1,600 in additional cash is needed. All the securities are donated. The cost basis of the securities given is \$850 + \$1,100 + \$1,440 + \$900 = \$4,290. Assuming a 15% long-term capital gains tax rate, the potential tax savings is $(\$8,400 - \$4,290) * 15\% = \$616.50$.

A few additional considerations: The above examples of the calculated tax savings do not include state or local taxes. Donating appreciated securities avoids these long-term capital gains taxes as well.¹³ Since combined state and local taxes range from 0% to around 10%, the additional tax savings may be substantial. For example, if combined state and local taxes were 5% in Example 2 above, the potential additional tax savings would be \$205.50 for a total of \$822. These examples also do not account for any transaction costs in repurchasing the securities (to replace the donated securities in the portfolio). Transaction costs could be zero as in the case of most mutual funds, though some funds do still have up-front sales loads. For equity purchases, a commission would generally apply — and donors should take this into account if they do, indeed, wish to repurchase the securities they donate.

How Many People Could Use Appreciated Securities for Their Charitable Giving?

Given the very substantial tax advantages that may be realized by donating appreciated securities instead of cash, and the relatively small share of total giving that takes this form, our research set out to determine how many people actually have the capacity to use appreciated securities — and what obstacles may be limiting their use of this option.

To gauge the sheer scale of the opportunity for potential giving with appreciated securities, we examined taxable brokerage accounts from a random set of households with minimum asset requirements at Fidelity Investments. For each household's set of eligible taxable brokerage accounts, we calculated the actual BVR and federal tax savings these households could potentially realize for two hypothetical desired giving amounts.

The first giving amount was \$10,000, the median 2004 contribution in donor advised funds¹⁴ (DAFs), the fastest-growing charitable vehicle in the United States today. (We discuss the ease-of-use advantages of donating securities through DAFs later in this report.)

Our second analytical benchmark was \$2,700, the median annual charitable donation as reported on IRS tax forms for the year 2004.¹⁵

Since one of our objectives was to measure the tax-savings opportunity among those households who would be reasonably likely to afford the median (DAF) contribution, we limited the final sample of households to those that had at least \$25,000 in total non-cash securities in their taxable brokerage accounts.¹⁶

The federal tax-savings opportunity was measured using actual tax lot data from the end of June 2004 — the latest period for which the data were available for our research. For the 2004 median donor advised fund contribution of \$10,000, the median potential federal long-term capital gains tax savings these households could have received by using appreciated securities instead of cash was \$449. This is a tax-savings percentage of 4.5% out of a theoretical maximum of 15% — the current federal tax ceiling on long-term capital gains.

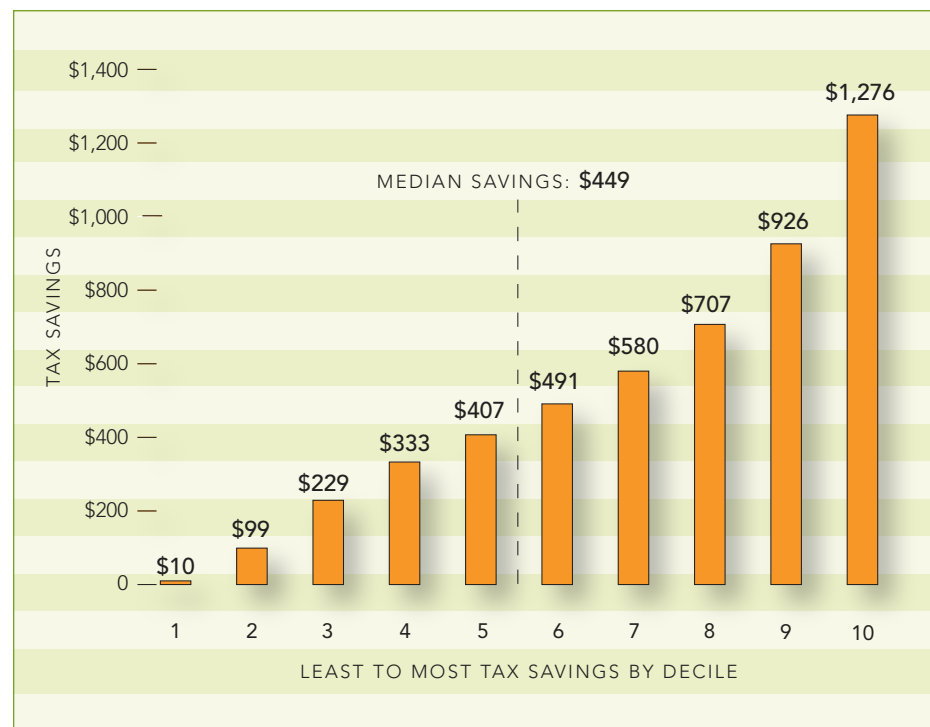
FOR THE 2004 MEDIAN DONOR ADVISED FUND CONTRIBUTION OF \$10,000, THE MEDIAN POTENTIAL FEDERAL LONG-TERM CAPITAL GAINS TAX SAVINGS THESE HOUSEHOLDS COULD HAVE RECEIVED BY USING APPRECIATED SECURITIES INSTEAD OF CASH WAS \$449

In evaluating the significance of this tax savings, it should be noted that securities which have doubled in value have a potential tax savings of 7.5%. So a median value of 4.5% savings (43% appreciation) across a large sample size suggests that on a society-wide level, many billions of dollars in substantially appreciated securities are potentially available to be donated to charity.

For the median 2004 giving amount of \$2,700 as reported by the IRS, the median potential federal long-term capital gains tax savings was \$131. This is a tax savings of 4.9%.

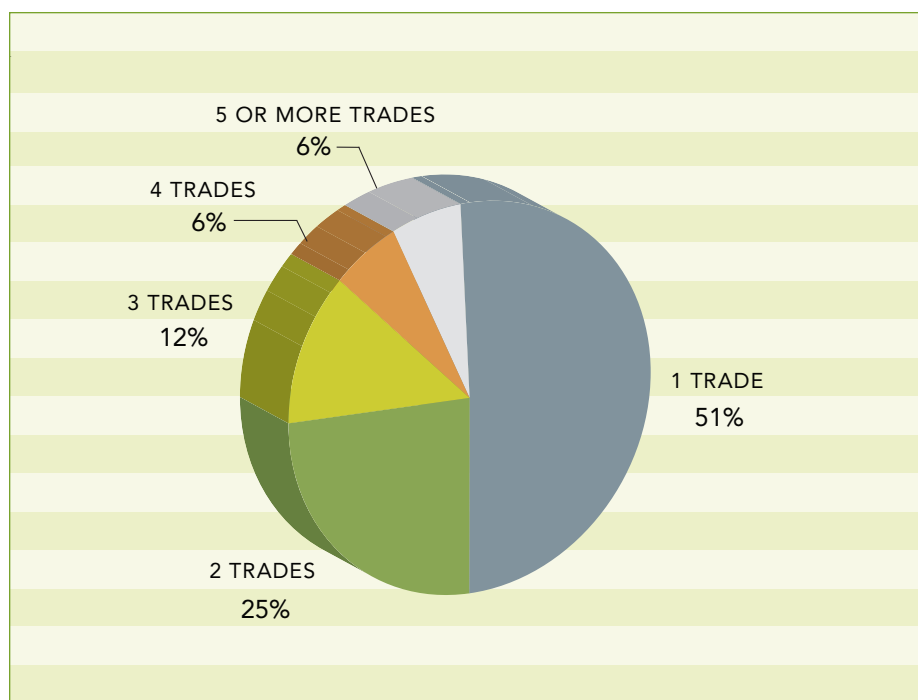
Naturally, some households can save more or less than others depending on the amount of unrealized long-term capital gain in their portfolios. We examined the savings opportunity by decile, from the 10% who could save the least to the 10% who could save the most.

Potential Federal Tax Savings by Decile for a Giving Amount of \$10,000



For a \$10,000 donation, the tax savings ranges from just \$10 in the lowest decile (the 10% with the lowest amount of tax savings) to \$1,276 in the highest decile (the 10% with the greatest amount of tax savings). Even if someone had a zero cost basis security, the maximum possible tax savings would be \$1,500. These cost savings do not account for the transaction costs of replacing the donated securities. For the vast majority of households (94%), only one to four security purchases would be needed.

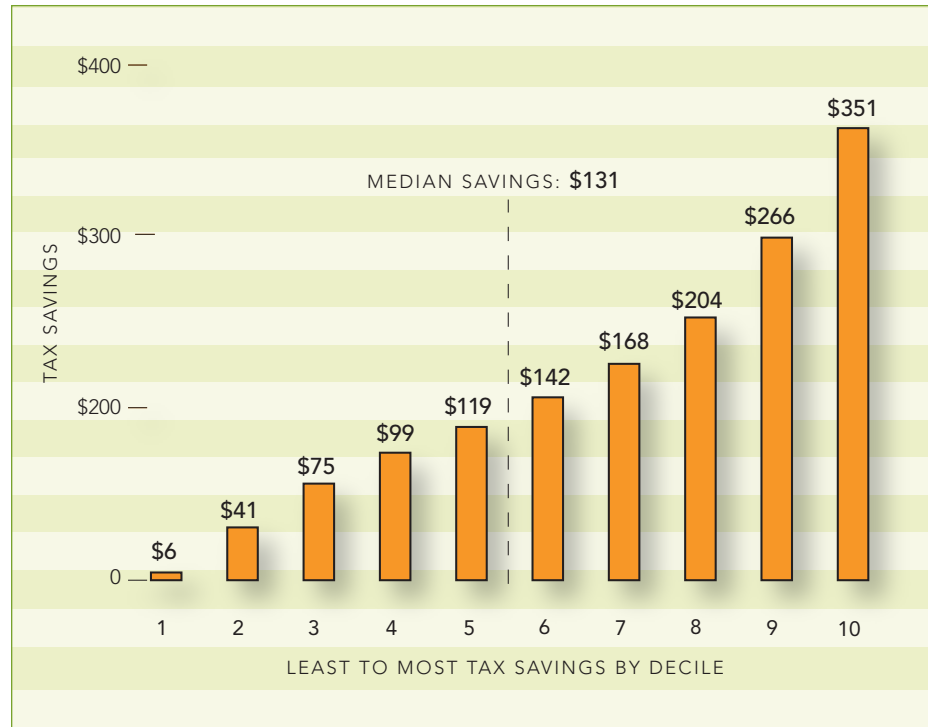
Even with transaction costs considered, 80% to 90% of households in the sample could have benefited from donating securities with long-term appreciation instead of donating cash.



Number of Trades Needed to Replace Donated Securities

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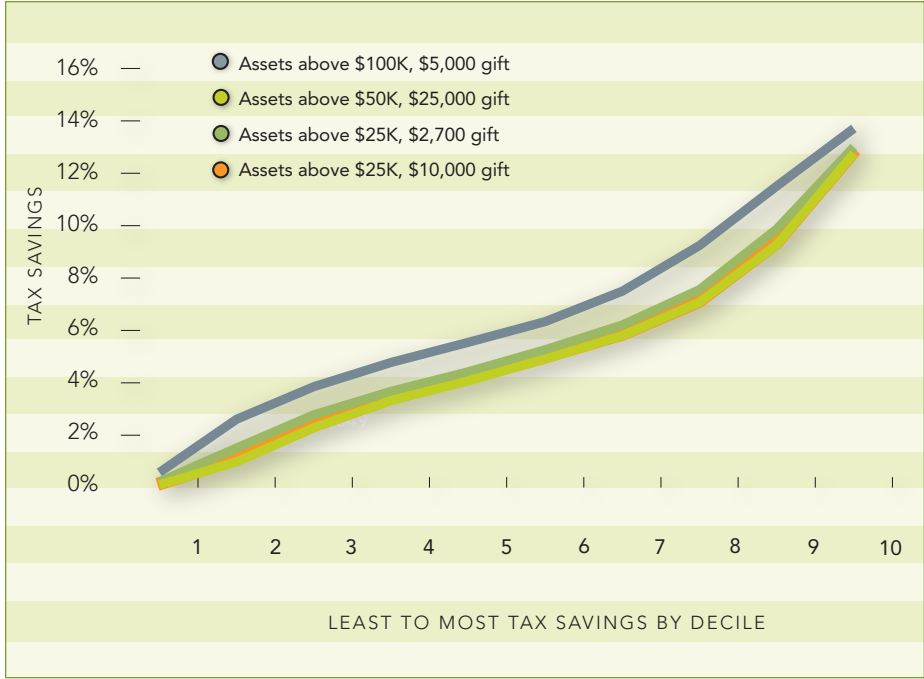
Potential Federal Tax Savings by Decile for a Giving Amount of \$2,700



Donating lower annual dollar amounts can also yield significant tax savings by avoiding capital gains taxes. For the 2004 IRS-reported median total giving amount of \$2,700, households in the sample could have saved from a low of \$6 to a high of \$351. The maximum possible savings is \$405. Generally, for this dollar amount, only one or two security purchases would be needed to replace the donated securities. So even with transaction costs, 70% to 80% of households in the sample could have benefited from donating securities with long-term appreciation instead of cash.

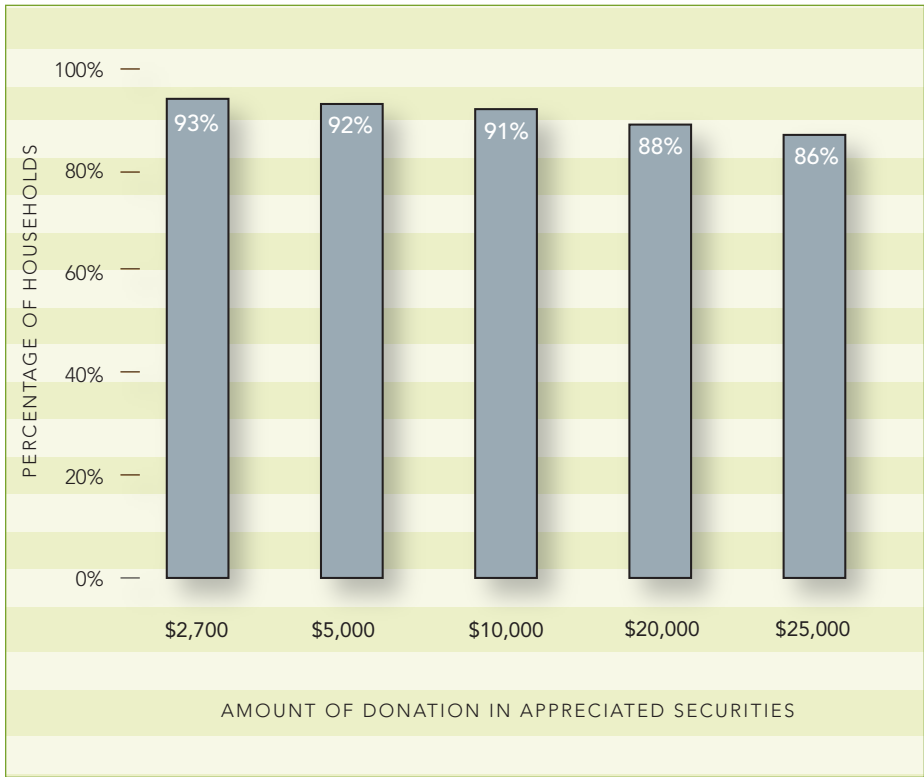
On a percentage basis, the federal tax savings ranges from near 0% to over 13% of the amount donated. Given a maximum possible tax savings of 15%, the top deciles have a very high potential for tax savings.¹⁷

THE TAX SAVINGS RANGES FROM NEAR 0% TO OVER 13% OF THE AMOUNT DONATED



Federal Tax Savings Percentage by Decile for Several Minimum Asset Levels

But what may be most remarkable is that the overwhelming majority of households in this sample hold enough appreciated securities to make these varying donations entirely from appreciated securities — as the chart below shows.



Percentage of Households with at Least \$25K in Non-cash Securities Able to Donate Various Amounts Entirely Through Appreciated Securities

THIRTY-NINE PERCENT OF RESPONDENTS DON'T WANT TO GIVE UP THEIR SECURITIES SINCE THEY ARE DOING SO WELL — NOT REALIZING THAT THEY CAN SIMPLY REPURCHASE THE SECURITIES

Fully 93% of these households with at least \$25,000 in non-cash securities in their taxable brokerage account had the capability to give the baseline median donation of \$2,700 entirely through appreciated securities and 91% could potentially fund the \$10,000 median donor advised fund contribution.

Of course, the proportion of securities (actually, tax lots) that is currently at a gain versus a loss position fluctuates with the performance of stock and bond markets. But given the positive market returns of 2005 and 2006, it is highly likely that the proportion of households that are capable of donating entirely through appreciated securities is even higher in 2007.

Yet, the scale of this opportunity to save on taxes by using appreciated securities instead of cash to give to charity is dramatically higher than reported behavior by the IRS. As we saw on the first chart in this report, cash contributions range from 82% of total contributions for AGIs less than \$60,000 to 55% of total contributions for AGIs between \$1 million and \$5 million. Even though transaction costs might make some donations of securities infeasible, a large proportion of cash contributions could have been made instead with appreciated securities — and middle-class and affluent households alike could have saved a substantial amount of money. Let's look at what our research shows are some of the reasons why this potential hasn't yet been realized.

Barriers to Giving with Appreciated Securities

To investigate the barriers to donating with appreciated securities, we conducted a survey¹⁸ targeting households with at least \$100K in total household assets (including retirement) and that have donated at least \$1,000 to charity in one of the last three years. Donations could have been spread out across multiple charities.

Households made donations using the following types of assets:

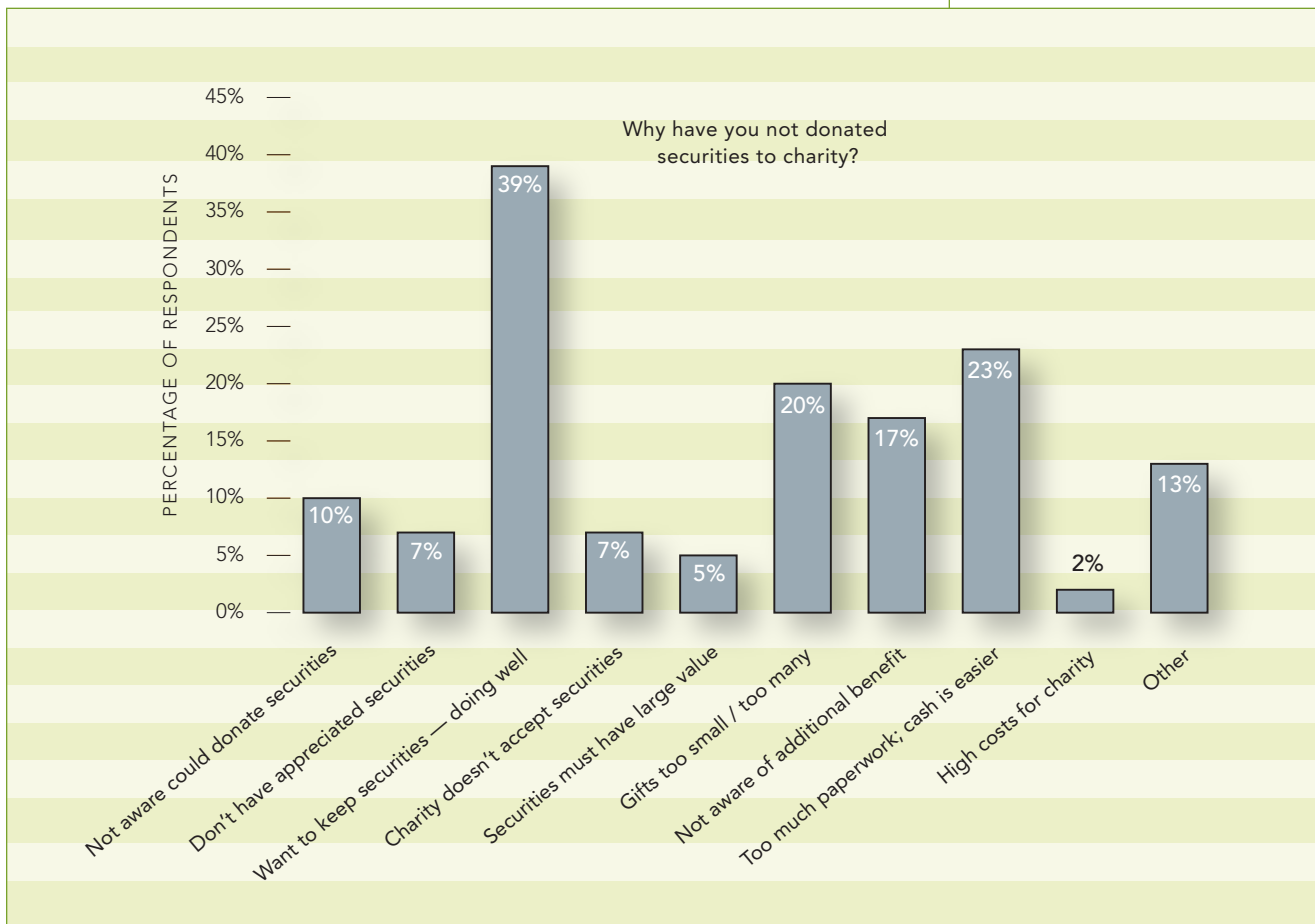
- Cash or check: **100%**
- Securities (stocks, mutual funds, etc.): **5%**
- Non-financial items (art, clothing, collectibles, etc.): **52%**
- Other (real estate, life insurance, professional services, etc.): **5%**

(Percentages add to more than 100% since many households gave with more than one type of asset.)

For the 95% of households that indicated they did not donate securities to charity, we investigated the barriers they perceived to doing so. Respondents were asked to list all the reasons why they have not donated securities. Although most respondents know that they can donate securities, there is much misunderstanding about the opportunities. Thirty-nine percent, for example, said that they don't want to give up their securities since they are doing so well — not realizing that they can simply repurchase the securities. Twenty-three percent cited the amount of paperwork

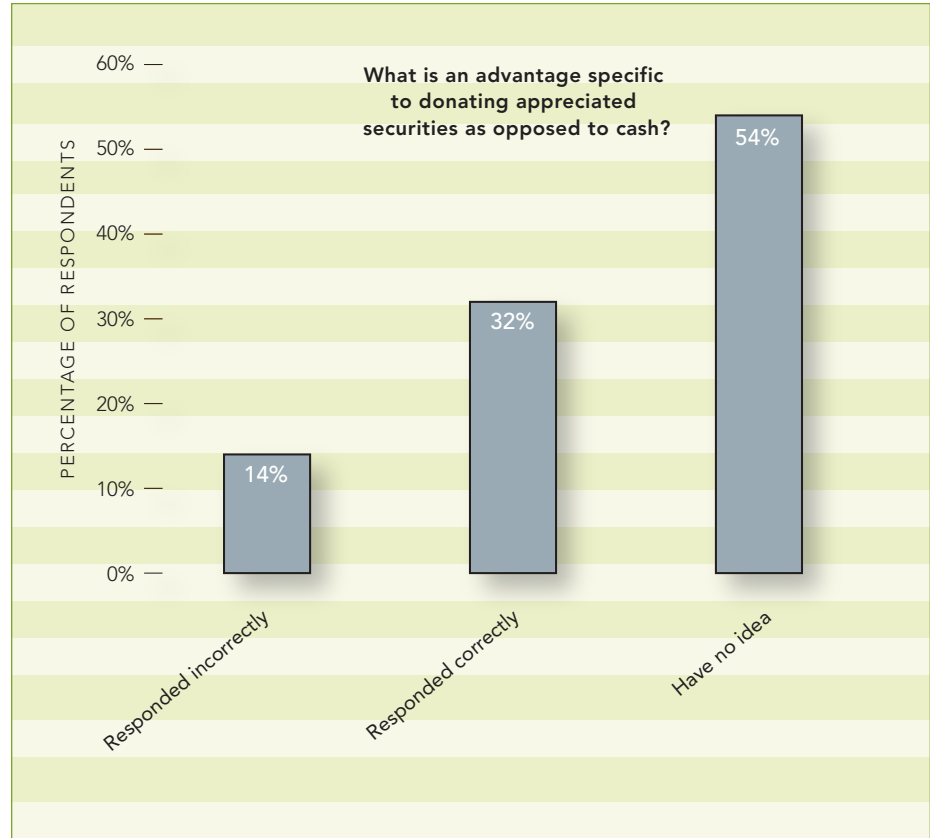
— not understanding the potential to utilize donor advised funds to eliminate the paperwork. What’s more, the sheer difficulty of donating securities directly to charity explains another 7% of the shortfall, since many individual charities do not accept securities. Again, donor advised funds address this barrier by accepting securities from their donors, but providing the charities to which they give grants the cash payments they generally prefer.

Perceived Barriers to Giving Appreciated Securities



In addition to these perceived barriers, we found there is also a profound lack of awareness of the tax advantages of donating appreciated securities. Only 32% of respondents knew of this additional tax advantage over and above the tax benefit from donating cash. Given that 68% of respondents either answered incorrectly or said they did not know the additional benefit, even when the benefit of reduced capital gains tax was offered as a response option, there is clearly a need for more education.

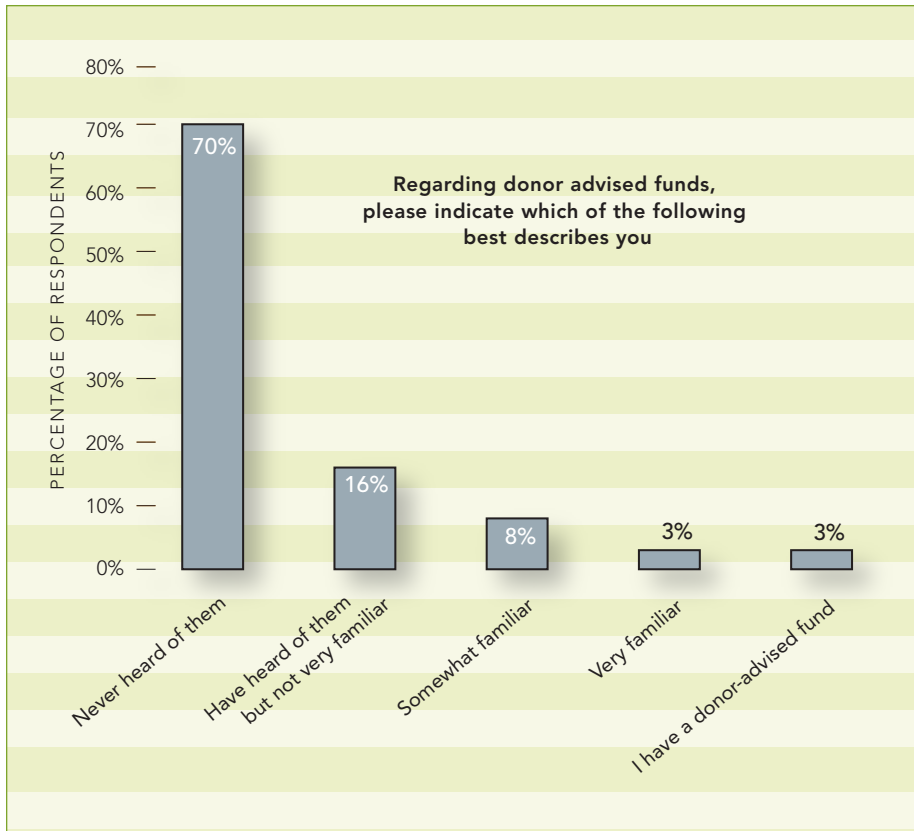
Awareness of Tax Advantages of Donating Appreciated Securities



There is a profound **lack of awareness** of the tax advantages of donating appreciated securities



Awareness of Donor Advised Funds



We found that there is a profound lack of awareness of donor advised funds as well. Seventy percent of respondents have never even heard of donor advised funds and an additional 16% are not very familiar with them. Clearly, this basic lack of awareness helps to explain why many households are not using DAFs for donating appreciated securities. Traditional charities and DAFs themselves, together with media that cover philanthropy, have major roles to play in educating the public about donating appreciated securities and about how donor advised funds make this financially-rewarding charitable solution easy to do. That is the subject we turn to now.

70% OF RESPONDENTS
HAVE NEVER EVEN
HEARD OF DONOR
ADVISED FUNDS

PART 2

EFFICIENT GIVING VEHICLES — DONOR ADVISED FUNDS

First, the basics. A donor advised fund (DAF) is a separate account of a sponsoring charitable organization. From this account, donors can recommend grants to other charitable organizations.¹⁹ DAFs generally accept contributions from donors in the form of cash or securities. As of May 2007, there were at least 149 sponsoring organizations of DAFs²⁰ in the United States, and they were the fastest-growing philanthropic vehicles in the nation.²¹ Yet DAFs still represent only a very small portion of total giving — \$6 billion in 2006.²²

The majority of these DAF programs have the ability to accept appreciated securities as donations. Some DAFs may accept other assets as well, such as real property or the cash value of life insurance. What DAFs do on receiving such gifts is to liquidate the donated assets tax free and invest the proceeds in one or more investment options. Generally, the donor can recommend how the assets are invested among a number of investment pools provided through the DAF's investment program. Over time, the donor recommends (advises) grants to one or more IRS-qualified public charities and the DAF's sponsor distributes cash grants to each of the recommended charities. Grants may be made over many years (subject to minimum grant activity requirements) even if a single donation was made to the DAF. In fact, one of the greatest advantages of a DAF is that giving may be done strategically for tax purposes and then grants made to charity over time according to the donor's wishes.

For donating to charity with appreciated securities, DAFs have an exceptionally high ease-of-use as compared with giving to charities directly. With a DAF, one donation of securities is made and then any number of subsequent grant recommendations may be made to individual charities.

By contrast, giving appreciated securities directly to charity requires working separately with each charity, which can take a substantial amount of time and effort. In addition, many charities either do not accept appreciated securities at all or will only consider them for very large donations. Donating appreciated securities to a DAF is easier not only because just one set of paperwork needs to be completed, but also because DAFs generally are set up to make the process easy and efficient for the donor. For most households, the emergence of DAFs has made giving with appreciated securities convenient and feasible. Without these funds, the potential added tax savings of donating appreciated securities could often be outweighed by the level of effort of actually making the gift.

WITH A DAF,
THE NET PROCEEDS
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DAFs are also highly efficient for the charities in terms of transaction costs on appreciated securities. Most charities use full-service brokers and generally pay much higher commission costs than DAFs, which generally use discount brokers. Thus, with a DAF, the net proceeds that a charity can receive are generally greater than the net proceeds a charity would get from securities donated directly to the charity.

Suppose, for example, that a person has \$20,000 in securities to donate to charity and is evaluating whether to give the securities directly to charity or to use a DAF. If the charity has to pay 1.5% to liquidate the securities, then the cost to the charity would be \$300 and the charity would net \$19,700. On the other hand, if the securities were donated to a DAF the liquidation costs may be just \$10 to \$75 meaning the charity could net an additional \$225 to \$290.

For all of these reasons, a much larger share of donations to DAFs are made in the form of appreciated securities than is true for charities nationally. The following chart presents the typical breakdown of donations to a DAF in cash versus appreciated securities.²³

Donations to DAF by Source ²⁴		
Year	Cash	Appreciated Securities
1999	22%	78%
2000	21%	79%
2001	33%	67%
2002	47%	53%
2003	38%	62%
2004	32%	68%
2005	31%	69%
2006	34%	66%

This “typical” breakdown is derived from data on donations to the *Fidelity Charitable Gift Fund*.

There is a significant amount of variation from year to year, which tracks closely with the performance of the stock market in particular. From a high of 79% — nearly fourth-fifths — of all donations in the “bubble” year 2000, flows of appreciated securities to the Gift Fund dropped to just 53% in the third down year of the 2000–2002 market plunge. That percentage has since climbed back to 66% as U.S. and global equity markets rebounded strongly from 2003 to 2006.

FROM AN ESTATE TAX
PLANNING PERSPECTIVE
USING A DAF IS FAR
MORE TAX EFFICIENT
THAN ANNUAL
DIRECT GIVING

Besides their short-term, tactical advantages, DAFs offer long-term strategic planning options as well: all donations made to a donor advised fund are removed from the donor's estate as soon as the donation is made. A large current-year donation to a DAF to be used for many years of future giving to charity immediately reduces potential estate taxes, whereas simply planning to give each year from the donor's assets provides no relief from potential estate taxes. So, from an estate tax planning perspective using a DAF is far more tax efficient than annual direct giving.

Choosing a DAF program and sponsoring charity should, however, involve careful consideration. In general, DAFs have minimum initial donations to establish an account, minimum additional donation requirements (generally smaller than the initial minimum contribution), and minimum grant recommendation amounts and grant activity requirements. We estimate that 10 to 20 million households have the potential to realize additional tax savings by donating securities with long-term appreciation to charity or to a donor advised fund instead of contributing cash directly to charities.²⁵ Households whose desired giving levels are below the DAF minimums may need to focus on direct gifts to charity. It should also be noted that donors may not recommend grants from their DAF where more than an incidental benefit will be received by the recommending donor or advisor, or even a family member of the donor or advisor. For example, DAF programs in general will not make grants where any goods or services will be received by the donor or other third person as a result of the DAF grant. Another limitation is that if someone pledges a donation, a DAF can't be used to satisfy that pledge.

Additionally, potential tax savings from donating appreciated securities must be weighed against the level of effort in establishing and funding a DAF, which varies across the industry. Next, donors should consider the fees DAFs charge for administrative and investment management costs — everything else being equal, the lower the fees, the more money that goes to charity. Of course, investment performance of the contributed assets and customer service to the donor matter greatly as well. Lastly, donors need to consider the level of effort a specific DAF requires in making grants to individual charities.

CONCLUSIONS

With 83% of Americans giving annually to charity, charitable giving is an integral part of the fabric of this country. In 2004 alone total donations to charity from individuals amounted to over \$187 billion — \$166 billion of it coming from individuals who itemized these donations on their tax returns.

But while Americans are indeed giving, and on a massive scale, they are too often giving inefficiently from a tax perspective. Ten to twenty million American households have the potential to realize additional tax savings by donating securities with long-term appreciation to charity or to a donor advised fund instead of contributing cash directly to charities. In short, millions could save billions or give billions more instead. So why aren't more Americans donating to charity with appreciated securities?

The answer is quite simple — most Americans surveyed either are not aware of the additional tax benefits of this strategy, do not want to give up their high-performing securities (not realizing they can immediately repurchase them), or say there is too much paperwork. Only 7% of respondents cited not having appreciated securities.

Most of the logistical barriers to donating appreciated securities can be addressed with a DAF. DAFs enable one donation of securities to be converted into many smaller potential grants to charities and have little paperwork when compared to giving directly to a charity. But only a small percentage of charitable donors are yet aware of DAFs.

What is needed to close this knowledge gap is a national campaign of investor and donor education about the tax-savings opportunities of giving with appreciated securities, and the ways that donor advised funds make such giving easy. Such an effort could help millions of American households sustain — and perhaps increase — the giving they already intend to do.

ADDITIONAL STRATEGIES FOR DONATING APPRECIATED SECURITIES

Charitable Gift Annuities

Charitably-minded individuals who have substantial holdings of appreciated securities and who are also seeking long-term income have another potentially valuable option to consider: *charitable gift annuities*.²⁶ There are a number of instruments which the IRS defines as “Split-Interest Vehicles” that enable a donor to contribute appreciated securities now, receive income for a period of time or for life and receive a partial income-tax deduction for the expected remainder that will pass on to charity in the future. These include Charitable Gift Annuities, Pooled Income Funds and Charitable Remainder Trusts. Determining which particular vehicle best meets your situation merits discussion with a professional planner. For simplicity, in this section, we illustrate the use of a Charitable Gift Annuity.

A gift annuity is a contract to provide fixed periodic payments for the lives of the annuitants. To set up a charitable gift annuity, a person donates the appreciated securities to charity in exchange for a promise of regular income (monthly, quarterly, annually, depending on the program) from the charity. The irrevocable gift of securities becomes the property of the charity, which then sells the securities in favor of other investments that are more suited to provide annuity payments. Although the funds from the gift are placed in their own account at the charity (for record-keeping purposes only) from which the annuity payments are made, the annuity payments are a general obligation of the charity. An annuity from a charity is, therefore, subject to the claims-paying ability of the charity, similar to how an annuity from an insurance company is subject to the claims-paying ability of the insurance company.

A charitable gift annuity has a couple of advantages. First, gifting appreciated securities avoids capital gains tax on the securities because charities are themselves exempt from such taxes. Income annuities from an insurance company may only be funded with cash, not securities, so purchasing an ordinary annuity would require an investor to first liquidate their securities and pay taxes on any gains. Second, the donation of appreciated securities to a qualified charity generates an itemized tax deduction for a portion of the gift amount. The amount of the tax deduction is determined by IRS rules²⁷ and depends on the ages of the donors among other things.

Consider the following hypothetical example: Sally and Dave, each age 65, want to increase their guaranteed income for life while at the same time benefit a charity they have supported for years. They own \$100,000 in appreciated mutual funds they purchased 20 years ago for \$30,000. If they sold the funds to purchase a standard commercially available annuity, they would pay \$10,500 in long-term capital gains taxes (assuming a 15% federal long-term capital gains tax rate and ignoring any state taxes and local taxes), netting \$89,500. As of July 2007, for each \$1,000 investment, a 100% joint and survivor fixed-income annuity would pay \$5.78 per month (an annual rate of 6.94%),²⁸ \$2.44 of which would be taxable and \$3.34 would be a tax-free return of principal.²⁹ For an investment of \$89,500, the monthly income would be \$517.31, \$218.82 of which would be taxable and \$298.49 a tax-free return of principal. Assuming a marginal federal income tax rate of 28%, net monthly after-tax income would be $\$157.55 + \$298.49 = \$456.04$. The return of principal occurs over the life expectancy of the annuitants, meaning payments after their life expectancy of 25.0 years would be fully taxable. There would be no benefit to charity.



If, instead, Sally and Dave donated the mutual funds to a qualified charity in exchange for an annuity from the charity, no capital gains taxes would be paid when the securities are sold (since qualified charities are tax exempt). Based on American Council on Gift Annuities (ACGA) rates as of July 2007, Sally and Dave could receive a 5.6% annual payout for life.³⁰ With a \$100,000 donation, the pre-tax monthly income would be \$466.67. \$65.94 of this monthly income is considered a return of the gift (the same as a return of principal) and is not taxed. \$246.40 is ordinary income and \$154.33 is capital gains. As with an insurance company annuity above, the return of the gift occurs over the life expectancy of the annuitants. So if Sally or Dave lives longer than 25.0 years, the remaining annuity payments would be fully taxable. Sally and Dave would also get to take a tax deduction in the year they make the securities donation to charity. In this case the tax deduction would be \$33,856.81. Assuming a marginal federal income tax rate of 28% and a long-term capital gains tax rate of 15%, the net monthly after-tax income would be \$374.53 and the value of the tax deduction could be as much as \$9,479.90.³¹ Of course, the charity gets a significant benefit as well. The annuity payments are set such that the charity should expect to keep at least 50% of the initial gift amount when the annuitants pass away. The actual expected amount will vary, among other things, due to the individual charity's expected investment return.

The discount rate of 4.04% was calculated as the average constant maturity 30-year treasury yield for July 2007 (5.11%) plus a constant insurance company yield premium of 50 basis points and then converted to an approximate after-tax discount rate. A tax rate of 28% was used to convert the yield to an approximate after-tax discount rate: $5.61\% * (1 - 0.28) = 4.04\%$

As the comparison table shows, the expected net present value of the charitable gift annuity (including the value to the charity) is greater than the expected net present value of the standard annuity. So for individuals like Sally and Dave, donating appreciated securities in exchange for a charitable gift annuity can meet the dual objectives of guaranteed income and charitable giving. These results hold at different discount rates as well. At a discount rate of 2% higher or 2% lower, 6.04% or 2.04%, the net present values are \$71,956 for the standard annuity vs. \$91,781 for the charitable gift annuity, and \$107,523 for the standard annuity vs. \$158,468 for the charitable gift annuity, respectively.

The benefits of the charitable gift annuity are largely due to a reduction in taxes. So the higher the capital gains tax rate and/or the greater the amount of unrealized gain, the greater the relative value of a charitable gift annuity. Additionally, if state and local taxes were included, the potential value of a charitable gift annuity would be even greater.

HYPOTHETICAL EXAMPLE:

Comparison of expected payouts and benefits to charity

	Standard Annuity	Charitable Gift Annuity
After-tax monthly income for 25.0 years (assuming a 28% tax bracket)	\$456.04 per month	\$374.53 per month
After-tax value of tax deduction (assuming the full amount can be utilized in the current tax year)	\$0	\$9,479.91
Value to charity (future value) in 25.0 years	\$0	\$100,519 (assuming a portfolio return of 5.61%)
Net present value at discount rate of 4.04%	\$86,989.87	\$71,442 + \$9,480 + \$37,353 = \$118,275

**APPRECIATED
COMPANY STOCK
IN QUALIFIED PLANS**

Appreciated company stock in qualified plans (e.g., 401(k) and ESOP plans) may also be used for charitable giving with special tax advantages. Electing Net Unrealized Appreciation (NUA) treatment of company stock can be an extremely tax-efficient strategy for charitable giving. Ordinary income tax is paid on just the pre-tax cost basis of the shares, but the federal itemized charitable tax deduction is usually based on the fair market value of the stock at the time it is donated, assuming all appreciation would have been taxable at the long-term capital gains tax rate if the shares were sold rather than donated. Essentially, with this strategy, the amount of the itemized charitable deduction is larger than the increase in income (by the amount of the NUA) so on balance taxable income is reduced. For more information on the strategy, see “Maximizing the Value of Company Stock at Retirement,” 2007, published by Fidelity.

**IMPORTANT LEGAL
INFORMATION**

The *Fidelity*[®] Charitable Gift FundSM is an independent public charity with a donor advised fund program. Various Fidelity companies provide non-discretionary investment management and administrative services to the Gift Fund. Charitable Gift FundSM is a service mark of the Trustees of the *Fidelity Investments*[®] Charitable Gift Fund. Fidelity and Fidelity Investments are registered service marks of FMR Corp., used by the Gift Fund under license.

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ENDNOTES

- ¹ An online survey of 2,939 U.S. adults conducted by Harris Interactive® between December 4 and 6, 2006 for *The Wall Street Journal Online*.
- ² Giving amounts do not include gifts from foundations, corporations, bequests, or non-itemizers. According to Giving USA, 2005, p.18, the respective giving amounts were \$28.8 billion, \$12 billion, \$19.8 billion, and for itemizers and non-itemizers combined: \$187.9 billion.
- ³ Cerulli Associates — Financial Planning Association Advisor Surveys, 2007.
- ⁴ Based on itemized cash giving of \$123 billion, tax-savings calculations with Fidelity accounts, and estimates of the percentage of households who own stocks or mutual funds outside of a retirement account among those households who itemize deductions.
- ⁵ All estimates of tax savings in this paper assume that donors who give cash instead of appreciated securities would have sold appreciated securities (and recognized the inherent capital gains) in an amount equal to the value of the cash donations in the same year that the cash donations are made. If the appreciated securities are not sold until some future date, the present value of the tax savings would be reduced. Potentially, capital gains taxes may be eliminated by holding the securities until death, with the beneficiaries receiving a step up in basis as of the date of death, although this could have adverse estate tax ramifications.
- ⁶ The cost basis of a security is generally the amount paid to purchase the security, adjusted for certain items such as commissions.
- ⁷ Assuming the charity is an IRS-qualified 501(c)(3) public charity. For gifts to a private foundation the limit is 20% of AGI. Amounts over the 30% (or 20%) threshold may be carried over for use in future years for up to five years. There is also a limit on the deductibility of cash contributions though it is 50% (30% for gifts to a private foundation) of AGI rather than 30% (20% for private foundations). For the vast majority of households, 30% of AGI is more than sufficient for charitable giving needs.
- ⁸ In this simple example, the transaction costs of repurchasing the securities are ignored. Note also that wash sale rules do not apply because the securities are donated rather than sold and because there are no realized losses involved (the securities are at a gain).
- ⁹ The Internal Revenue Service has restrictions on what cost basis methods can be used and when they can be changed. Although different methods may be used for different securities, once an average method is used for a security, all of a person's holdings of that particular security are subject to the average method unless the consent of the IRS is obtained to change the method.
- ¹⁰ Exceptions apply. Some securities in a portfolio such as stock options or bonds may never go long term since they would expire or mature before being held for over 1 year. It may be advantageous to donate these securities and deduct only the basis (cost of the options) rather than sell them (which would increase AGI and potentially contribute to the phaseout of itemized deductions or exemptions), pay short-term capital gains taxes and donate the net proceeds.
- ¹¹ Donations of securities with unrealized long-term gain are generally more tax-efficient for the donor because of the potential for claiming an itemized deduction for their full market value. The deduction for donations of securities with unrealized short-term gains is usually limited to the donor's basis; however, such donations are generally allowed up to 50% of AGI rather than the 30% for securities with long-term appreciation. (Note that both these limits are lower for certain types of charities.) This presents another tax-efficient donation strategy as it allows a person trying to offset a one-year income spike to potentially claim a charitable donation of up to 50% of their AGI by donating securities with minimal short-term appreciation rather than being limited to a charitable deduction of 30% of AGI for the full market value of donations of securities with long-term appreciation.
- ¹² If a tax lot with an unrealized loss is sold and then replaced, it is important not to run afoul of the wash-sale rules that require a waiting period of 30 days to repurchase the security; otherwise, the realized loss is disallowed for tax purposes.
- ¹³ Taxation at the state level varies considerably. Realized capital gains may be taxed as long-term capital gains, short-term capital gains, ordinary income, or not at all.
- ¹⁴ The 2004 median Fidelity donor advised fund contribution to the *Fidelity Investments*® Charitable Gift FundSM (a 501(c)(3) public charity with a donor advised fund program (the "Gift Fund") for new accounts was \$10,000. It is important to note that the Gift Fund's minimum contribution amount to establish a donor advised fund was \$10,000. For the donor advised fund industry as a whole, median contribution amounts are not publicly available, though common contribution minimums of \$10,000 and \$25,000 would indicate a median donor advised fund contribution higher than \$10,000. In 2007, the Gift Fund lowered its initial contribution minimum requirement to \$5,000.
- ¹⁵ The 2004 median total annual charitable donation is an approximation based on charitable donations for AGI ranges as reported by the IRS.
- ¹⁶ Tax lots with unrealized short-term gain were excluded since, generally, these lots are not a tax-efficient means of charitable giving. Households had varying amounts of cash in Fidelity accounts and may have also had substantial amounts of cash and/or securities outside of Fidelity accounts. To be eligible, a household needed to have at least one tax lot with cost

basis information in one giving-eligible account. Tax lots with missing cost basis information were excluded, so the giving opportunity may be greater than reported here. A giving-eligible account is a taxable account which may be legally donated to charity and whose gains and losses are reported on the household's individual tax return.

- ¹⁷ As one would expect, when the donation amount is a smaller proportion of assets (e.g., a \$5,000 gift when assets are above \$100,000), the tax efficiency is greater than when the giving amount is a higher proportion of assets (e.g., a \$2,700 donation when assets are above \$25,000). This is because the lower the proportion of the donation to assets, the easier it is to just give the most tax-efficient lots. Still, it is interesting that while across deciles there is a great variation in tax-efficiency, across asset levels and giving amounts there is relatively little variation.
- ¹⁸ An online panel survey targeting households with at least \$100K in total assets, who also report holding securities in a brokerage account and who report donating \$1,000 or more to charity within the last three years, was conducted among 508 household financial decision-makers by Richard Day Research of Evanston, IL on behalf of Fidelity from September 11-13, 2007
- ¹⁹ After the enactment of the Pension Protection Act on August 17, 2006, the Internal Revenue Code defined a donor advised fund as a separate fund (or account) of a sponsoring charitable organization with respect to which a donor (or person named by the donor) can recommend grants to other charitable organizations or may make investment recommendations. Irrevocable contributions from the donor are made to the sponsoring charitable organization (a public charity) and are allocated to the individual donor advised fund. The charity is the legal owner of the DAF and the balances in the DAF.
- ²⁰ Chronicle of Philanthropy. Based on survey responses from May 2006 and May 2007. There may be as many as several hundred more as most community foundations have a donor-advised fund program as well.
- ²¹ Investment News, September 17, 2007. Lisa Shidler. Donor advised funds are seen becoming more popular. Assets in donor advised funds climbed 24% last year, making the funds the fastest-growing charitable vehicle.
- ²² Chronicle of Philanthropy, May 2007.
- ²³ Breakdown based on data from the *Fidelity Charitable Gift Fund*.
- ²⁴ In each year there were also small amounts of other types of donations (less than 1%) such as the cash value of life insurance and real estate.
- ²⁵ This estimate is based on reported charitable donations on IRS returns, equity ownership data (including mutual funds) from the Federal Reserve, and an analysis of securities with long-term appreciation among the sample of Fidelity brokerage accounts. According to the Survey of Consumer Finance conducted by the Federal Reserve Board in 2004, there were approximately 112 million households in the U.S.
- ²⁶ Other types of charitable gift annuities besides immediate annuities may also be available. The annuity may be deferred — a Deferred Payment Gift Annuity — where the annuity payments start more than 1 year after the charitable donation. There are also college tuition gift annuities where the annuity payments are geared to pay for a child's college tuition.
- ²⁷ Tax calculations performed using GiftLaw charitable gift annuity tool. Applicable federal rate (AFR) of 6.2% for August 2007 was used. Annuity percentage: 5.6%. See http://www.giftlegacy.uci.edu/giftlaw/glaw_calculator.jsp.
- ²⁸ Annuity quote is from Cannex, July 2007. The Cannex quote is the industry average value for all insurance companies that provide their annuity data to Cannex. Annuity quote is for a fixed level-payment monthly annuity with no guarantee period.
- ²⁹ Tax-free return of principal is calculated according to IRS publication 939: General Rule for Pensions and Annuities. Joint life expectancy for Sally and Dave according to table VI is 25.0 years. The expected return is $\$517.31 * 12 * 25.0 = \$155,193$. The exclusion ratio is thus $\$89,500 / \$155,193 = 57.7\%$.
- ³⁰ See <http://www.acga-web.org/2006ratesjuly/twolifejuly06.html>. Rates for July 1, 2007 to June 30, 2008 are unchanged from those of July 1, 2006 to June 30, 2007.
- ³¹ Tax calculations performed using GiftLaw charitable gift annuity tool. \$466.67 monthly payment consists of \$246.40 in ordinary income taxed at the 28% rate, \$154.33 distributed long-term capital gains taxed at the 15% rate, and \$65.94 in tax-free return of gift. After federal taxes only, the net payment is \$374.53. If state and local taxes were included, the net payment would be lower. The tax deduction of \$9,479.90 is obtained by multiplying the gift amount (\$33,856.81) by the 28% assumed marginal federal income tax rate.

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