Alpha through Efficient Giving

by Ryan Boland, JD, CFP®

For family office investment professionals, the quest to deliver alpha for their family clients is constant.

Alpha is traditionally thought of as excess investment return delivered by a manager compared to a benchmark index. Sometimes tax alpha—the excess return achieved by taking advantage of tax efficiencies when investing—is also considered. This article introduces a third concept: philanthropic alpha. While philanthropic alpha might contribute to tax alpha as clients' tax burdens are potentially reduced through charitable giving, philanthropic alpha can also be understood as additional capital, realized through smart planning, that can be put towards charity.

This article shares the best practices utilized by highly successful family offices with the goal of encouraging linking both the investment side of the family office with the philanthropic team, resulting in a greatly more efficient deployment of capital.

Aligning direct investment strategies with large-scale philanthropy

Many family offices are increasingly employing direct investment strategies, sometimes deploying capital away from hedge funds, traditional private equity fund allocations, and the publicly traded markets and towards private operating businesses. These investments, combined with the reality that some family offices also maintain a controlling interest in the private operating businesses that generated their family clients' wealth, combine to create a portfolio that is increasingly dominated by private assets.

These direct investment strategies, which are separate from the interest in the family business, are sometimes called fundless investments and often allow the family office to have greater control over the investment while eliminating a layer of fees and ideally offering the prospect of higher returns. In some cases, the family office will acquire a controlling interest in an operating business in an industry familiar to the family. In other instances, they may have a minority interest in a business working either with a syndicate, an independent sponsor, or in concert with other family offices in club deals where there is a particular trust level between families. Often a multi-family office will also enable multiple clients to gain access to invest in early funding rounds for promising private businesses.

At the same time, many family offices are pursuing significant philanthropic plans on behalf of their founders. Since the investment success of the family office ultimately enables the clients' large-scale philanthropy, it is appropriate to think of alpha as an increased philanthropic impact realized through tax-efficient funding of charitable contributions, and opportunistic funding decisions are critical to maximizing the capital available for philanthropic use.

In the end, having an investment portfolio achieve a return 30% above a benchmark or executing a charitable gift of the same dollar value in a 30% more tax efficient manner will have the same net impact on the capital allocation for a family office. If the investments are successful but major philanthropy is accomplished inefficiently, the overall impact of the capital would be greatly reduced. By thinking of alpha in this way, the family office can ensure that the most good is being accomplished with the capital available.

Tax-efficient giving

Many large gifts of $30 million or more are still made with cash *following* liquidity events. Clients can sometimes pay up to 35% in Federal, State, and Local taxes after a large liquidity event. However, with enough advanced planning, assets can be contributed *prior* to the liquidity event, qualifying for a charitable deduction that may minimize their taxes, while providing significant funds for charitable purposes.

For example, a client who donates highly appreciated privately held assets to a public charity—such as Fidelity Charitable®, a public charity and sponsor of a donor-advised fund—is generally eligible to claim a fair market value charitable income tax deduction.[1] In addition, when contributed assets are sold by the public charity, the charity is not subject to any capital gains tax.[2] When the fair market value deduction is combined with the tax efficiency of the charity as the owner of the appreciated asset, the full efficiency of giving private assets is revealed.

[1] *A donor may qualify for a charitable deduction in the year the contribution is made, subject to IRS limitations. The Fair Market Value is determined by a qualified appraiser and in compliance with IRS rules and regulations.*

[2] *For some assets, the public charity will experience unrelated business income tax (UBIT) during its holding period or through its sale of the asset.*

Types of assets

The assets that are often given pre-liquidity in this context include private company stock— sometimes where there is the possibility of the sale or reorganization of a family business and sometimes in a situation where a family office was simply an investor in a private company heading for a liquidity event or a funding round. The asset can also be an interest in a Co-Invest LLC that holds shares in a private company that may have a sale in the near future. In some instances, the underlying asset of an LLC or LP can be commercial real estate such as an office tower or shopping mall that may have the potential for an upcoming sale. In all instances, there may be an opportunity to use the appreciated business interest as a charitable contribution.

How Fidelity Charitable® can help

Using a donor-advised fund like a Giving Account® at Fidelity Charitable to accomplish a contribution of privately held assets can often help in the planning process in a few important ways.

First, at Fidelity Charitable, the Complex Assets Group is a team of experts dedicated to helping donors and advisors with the charitable contribution of privately held assets.

Second, many public charities cannot easily accept appreciated privately held assets. However, if using a Giving Account at Fidelity Charitable, a donor family can irrevocably contribute privately held assets directly to Fidelity Charitable. Fidelity Charitable liquidates the assets, realizing the tax advantages mentioned above, and the proceeds become available in the Giving Account. Families can then support nonprofit organizations by recommending grants from the Giving Account.

Third, though many family offices well-suited for a complex asset contributions also have a private foundation,[3] private assets contributed to a non-operating private foundation would generally only be able to claim a deduction equal to the donor's tax basis in that asset, not the asset's fair market value. In these cases, it often makes sense for family offices to use *both* a Giving Account and a private foundation to accomplish their philanthropy.

Developing a holistic planning approach

A truly holistic planning approach compels the investment strategy to be closely aligned with **both** the tax team and the team leading the philanthropic efforts. This close alignment is required if the teams are to achieve the highest possible net planning alpha.

The following are some best practices to ensure proper alignment across a family's investments, tax and philanthropy teams.

1. The investments team shares with the philanthropy team forecasts for private investments that give a two to three year lens on potential liquidity opportunities.

In the case of private business stock, the projected liquidity event could be the sale of the entire business, the sale of a percentage of the business (perhaps to another shareholder or a private equity firm), or even a looming stock buyback by the company. In a similar manner, for private equity or venture capital investments, the potential exit event could be a sale of the underlying portfolio company or it could be the LP investment beginning to make distributions.

2. The philanthropy team maps out and shares multi-year targets for large gifts.

This interplay can be circular at times as the opportunity for large gifts is only possible with large liquidity events. However, at many family offices the portfolio is diverse enough to reasonably be able to predict when there will be some sizable events at varying intervals.

3. The tax team shares the planning options available to ensure that the multi-year tax impacts of the projected liquidity events and potential gifts are well coordinated to maximize the charitable income tax deductions in years with significant liquidity events.

This element can be particularly important when the investments team is not located in the United States and, as a result, may not have Federal Income Tax implications as a driver in all decision making.

4. The investments team includes philanthropy as a consideration when contemplating possible exit alternatives.

In some instances, the potential liquidity event may be voluntary, such as a tender offer being presented or the ability to sell shares as part of a funding round. If viewed purely through the investment lens, the investment team may opt to not participate. If the philanthropic goals are also layered into the decision-making process, it may be more impactful to pursue a charitable gift of the asset and allow the recipient charity the opportunity to participate in the exit.

5. The philanthropy team maintains a routine dialogue with the charitable organization(s) so both organizations can share considerations and set proper expectations for diligence and timing requirements.

This will allow for an early assessment on the suitability of the asset for charitable contribution and will allow for the contribution to be well coordinated to ensure that a compliant and efficient contribution can be achieved.

[3] A private foundation that principally provides grants to other entities or to individuals for charitable or other exempt purposes would not qualify as an operating foundation, and instead would be called a "nonoperating foundation".

Case Study[4]

Consider a single-family office, founded by a hedge fund founder that is planning for a $50M contribution to an institution dedicated to cancer research.

On the investment side, the family office expects to have a large liquidity event in the next two years:

There will be an expected sale of a unicorn private business in which the family office holds a minority interest of shares in a C corporation. The initial investment of $40M is expected to result in a $100M realization. The family office, being located in New York City, calculates that the rough expected combined federal, state and local capital gains tax rate on the $60M gain to be approximately 36%.[5]

$50,000,000

Sell stock and use after-tax proceeds to fund charitable giving	vs.	Contribute private company stock directly to charity
$10,800,000[6]	Total taxes paid (36%)	$0
$39,200,000	Federal Charitable Income Tax Deduction	$46,000,000[7]
$39,200,000	Charitable contribution	$50,000,000[8]

By contributing the private stock directly to a nonprofit, like Fidelity Charitable, the family becomes eligible for a substantially higher deduction and an additional **$10,800,000** becomes available for charity.

Conclusion

When considering how family offices can best deliver alpha to their clients, smart philanthropic planning must enter the equation. The entire team—investment, tax, and charitable giving professionals—must work together and plan ahead. By advising clients to contribute the right asset, at the right time, to the right entity, family offices can execute tax-efficient donations that contribute to the realization of alpha and provide more dollars to the charitable causes their clients choose to support.

[4] This hypothetical case study is provided for illustrative purposes only. It does not represent an actual donor, but is meant to provide an example of how a donor-advised fund can help individuals give significantly more for the causes they care about. This experience may not be representative to the experience of all donors and/or advisors.

[5] The 36% tax rate in this hypothetical example is calculated based on a combined tax rate of federal capital gains tax rate of 20%, Medicare surcharge of 3.8%, New York state tax rate of 8.8% and New York city local tax rate of 3.876%.

[6] Aligned with the $60M gain on the $100M realization, taxes are applied to $30M of the $50M in shares being sold.

[7] An 8% valuation discount is applied for lack of marketability and minority interest. Discounting in the valuation can vary greatly and is dependent on the facts and circumstances of the contribution. See Instructions to IRS Form 8283 for further reference.

[8] This illustration assumes that the donor is able to claim a deduction for charitable contributions of appreciated assets up to the maximum tax limitations of 30% of adjusted gross income.

891520.1.0

FIDELITY Charitable℠

Make more of a difference