In today’s world, pursuing your life’s goals is being challenged in new ways. Which makes now the perfect time to review your goals in terms of “Advice. Beyond investing.” Because when we collaborate on what matters most to you, we can create a plan tailored for you.

Private foundation
Supporting organizations
Case studies
In conclusion

* Investing involves risks, including the potential of losing money or the decline in value of the investment. Performance is not guaranteed.
Many families create their charitable foundations with big dreams and ambitious goals. Perhaps they are in the midst of selling a business or settling the estate of a family member, and like the idea of making an impact on causes they care about. At the time, creating a vehicle to bring the family together around a shared set of values, as well as the potential income tax benefits, is exciting. In other situations, children or grandchildren may have inherited a family charitable entity that was created by previous generations, and the foundation can feel like a burden if the inheriting generation wasn’t prepared for the responsibilities they’ve been given.

As we frequently see, circumstances change, and the best laid plans do not always turn out as envisioned. It is not unusual for a family to decide that the charitable vehicle that the family created is ultimately not be the right type of entity to meet the family’s philanthropic goals. It often takes a few years for a board to fully strategize and build out their philanthropic plans as they learn a new landscape; when they do, they might find the family giving needs have changed. Other times, the issue that founders thought they wanted to tackle ends up manifesting differently with multiple generations involved. Another example is when the family experiences something that drastically shifts their funding priorities. In all of these situations, the vehicle they initially set up might not serve their purposes as well as a different vehicle might, in light of their new circumstances. The wonderful news—there are options that exist!

First, let us start with the basics of charitable foundations. For purposes of this discussion, we will focus on vehicles for donors or families who are looking to exert more control and autonomy with their philanthropy. This may be a new entity, or in some cases, the original choice of the charitable entity’s structure may need to be re-considered. When donors seek more control, charitable strategies can include private non-operating foundations, private operating foundations, or entities that exist primarily to support a public charity (called “supporting organizations”). We will review these different vehicles and examine some case studies which question either the existing structure or the way the charity carries out its charitable purpose.

### Private foundation

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Non-operating private foundation</th>
<th>Operating private foundation</th>
<th>Type 1 Supporting organization</th>
<th>Donor advised fund</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Amount deductible</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Publicly Traded Securities</td>
<td>FMV</td>
<td>FMV</td>
<td>FMV</td>
<td>FMV</td>
</tr>
<tr>
<td>Other Appreciated Property (i.e., closely held assets or real estate)</td>
<td>Cost basis</td>
<td>FMV, provided the property has been held for one year or more</td>
<td>FMV, provided the property has been held for one year or more</td>
<td>FMV, provided the property has been held for one year or more</td>
</tr>
<tr>
<td><strong>Deductibility, % Limits of AGI</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>30%</td>
<td>60%</td>
<td>60%</td>
<td>60%</td>
</tr>
<tr>
<td>Appreciated publicly traded securities</td>
<td>20%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
</tr>
</tbody>
</table>
### Additional considerations

<table>
<thead>
<tr>
<th></th>
<th>20% (limited to cost basis)</th>
<th>30%</th>
<th>30%</th>
<th>30%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other appreciated &quot;complex&quot; assets, subject to related use rules</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Excess Business Holding Limits

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>Yes</th>
<th>Yes, for Type II and Type III Supporting Organizations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1.39%</td>
<td>1.39% in most cases</td>
<td>None</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Donor Control</th>
<th>Legal control</th>
<th>Legal control</th>
<th>May appoint a minority of board members</th>
<th>Advise as to grants, investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anonymity</td>
<td>Detailed tax return provides information on grants, donors, investments, fees, and salaries</td>
<td>Detailed tax return provides information on grants, donors, investments, fees, and salaries</td>
<td>Limited</td>
<td>Yes, donors and grants can be private</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>5% distribution requirement</th>
<th>Yes</th>
<th>No</th>
<th>No</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incorporation, Tax Exemption, Audit/Tax Returns, Directors/ Officers, Grant Management, Investment Management, Compliance</td>
<td>Responsible for all of these duties or can pay to outsource.</td>
<td>Responsible for all of these duties or can pay to outsource.</td>
<td>Share duties between Supporting Organization and Supported Organization assumed by sponsoring entity</td>
<td>Typical fees between 50 – 1.5% and duties fees typically more than DAF but less than foundation.</td>
</tr>
</tbody>
</table>

There are two types of private foundations for families: “non-operating” and “operating”. The most common type of private foundation is a private non-operating foundation. A private non-operating foundation allows the board to actively participate in their philanthropy primarily through supporting individuals or entities. A private non-operating foundation is required to grant out 5% of their previous year’s average assets, often referred to as the minimum distribution requirement or MDR. To do that, the foundation has the latitude to pursue a wide variety of activities to meet its charitable goals. Private non-operating foundations can create scholarship or award programs, issue emergency or hardship assistance to individuals, issue loans, run programs called direct charitable activities, and more. A private operating foundation, by contrast, devotes a major portion of its financial resources directly to the active conduct of a charitable purpose. Examples include...
operating direct programs such as museums, libraries, research laboratories, parks and “think tanks”.

One benefit of the private operating foundation model is that it allows the founding donor or family to invite others to contribute to its endowment for the programs or services it supports, and for these other donors to receive the same tax benefits as for gifts to a public charity. A donor to a private non-operating foundation is usually limited to a cost basis deduction of any asset other than cash or publicly traded stock (for example, closely held stock, or real estate). By contrast, a donor to a private operating foundation may deduct the fair market value of appreciated complex assets such as closely held stock and real estate. The same deductibility limits apply to private operating foundations as apply to public charities.

Like all private foundations (except for a handful of “exempt operating foundations”), private operating foundations are subject to an excise tax of 1.39% on their net investment income. This tax must be reported on IRS Form 990 PF and paid annually in quarterly installments if the total tax for the year is $500 or more. Some private foundations seek to minimize this excise tax by making grants to public charities of appreciated securities, rather than realizing net investment income inside the private foundation.

All private foundations, both operating and non-operating, may also be subject to excise taxes for engaging in certain financial transactions, such as (1) for certain acts of self-dealing between the private foundation and its disqualified persons; (2) for failing to make a minimum annual payout for charitable purposes; (3) for excess business holdings; (4) for jeopardizing investments; and (5) for making certain types of prohibited grants and payments known as taxable expenditures, including payments for legislative lobbying or to influence the outcome of a public election and certain types of grants to individuals. Private foundations must disclose their schedule of contributors as well as the grants they have made.

Supporting organizations
Generally, to qualify as a public charity, an organization must pass what is called the “public support test.” While most public charities qualify for this designation by receiving direct support from the public, supporting organizations qualify as public charities because they support either another public charity or the charitable activities of a 501(c)(4), (5), or (6) organization. Thus, supporting organizations are considered by some to be a hybrid of private foundations and public charities that generally enjoy more favorable tax treatment than private foundations because they are exempt from the excise taxes imposed on net investment income that apply to private foundations.

With the passage of the Pension Protection Act of 2006, most types of supporting organizations have become less desirable as philanthropic vehicles because of the restrictions imposed by the tax law, but they are still the right fit in certain situations. A typical supporting organization makes grants only to those public charities designated in its governing instruments. Because of this close relationship with a public charity, a supporting organization is treated as a public charity for income tax purposes, i.e., the 60% income limitation applies for contributions of cash and the 30% of income limitation applies for contributions of stock. In addition, donors are permitted to serve on the entity’s board, as long as they do not have a controlling role. Another change that occurred under the Pension Protection Act of 2006 is that most supporting organizations are now subject to the same excise tax as private foundations.
As with most complex issues like this, the choice between a supporting organization and a private foundation is far from automatic.

foundations for “excess business holdings” (a tax specifically intended to limit holdings of closely held stock by supporting organizations), although they are not subject to excise taxes on net investment income.

A supporting organization is, by default, considered subordinate to and controlled by the charity it supports. This lack of independence is often the reason the same large donor above may choose a private foundation instead of a supporting organization. The tax benefit might not outweigh the freedom factor. Unlike a private foundation, a supporting organization cannot have a closely controlled board of directors. In addition, there will need to be overlap or even duplication of the board members from both the supporting organization and the supported public charity. The degree of overlap depends on the type of supporting organization.

As with most complex issues like this, the choice between a supporting organization and a private foundation is far from automatic. It requires careful analysis to ensure that the balance of benefits falls in the right direction and positively impacts both the funding organization and the ultimate recipient charity.

**Case studies**

Now that we have reviewed the basics, let us look at a few cases in which a family starts with one charitable tax structure, but as circumstances change, explores whether a different structure or approach may better suit their charitable goals.

**Case 1: Private non-operating foundation to operating foundation**

Let us look first at a family where the founding generation were avid collectors of art, and used their non-operating foundation to provide grants to young artists for living expenses to give them the time to create. When that generation passes away, their children and grandchildren might choose to honor their legacy by converting to an operating foundation, donating the first generation’s art collection to the foundation, and displaying the collection in a family museum. They would be able to accept donations as well as charge an admission fee to sustain the museum. The family should consider how hands on they want to be; since an operating museum would generally require infrastructure, insurance, staff, and various other costs; they should be prepared for the work involved. Another option would be for the family to remain a non-operating foundation that owns the works of art and loans them out as charitable use assets. A piece displayed as “on loan from The Family Foundation” is considered a charitable use asset and excluded from the 5% Minimum Distribution Requirement calculation. It is important to remember however, that by remaining a non-operating foundation, the family would be limited to a cost basis deduction for donations to the foundation. If the art collection is passed to the next generation after the death of the original owners, it will get a stepped-up basis, and could be gifted by the estate to a non-operating foundation at fair market value.

**Case 2: Choosing an operating foundation from the start**

Over the years, a second family has made several large gifts to public charities that rescue animals. They have also engaged in direct philanthropy by rehoming rescued animals on their own ranch and they would like to explore donating part of the ranch to a charity that rescues animals. The three options are: (1) donate a portion of the ranch to their own private operating foundation and manage the rescue efforts themselves; (2) create a non-operating foundation and loan the ranch to a local charity for these purposes; or (3) gift the ranch to a charity outright. This is where the tax considerations
may be a significant factor, as the family is already doing much of the work themselves. If they donate a portion of the ranch to a private non-operating foundation, their income-tax charitable deduction is limited to their cost basis in the portion of the ranch they donate. However, if they donate the land to a private operating foundation or create a supporting organization for a local charity, they would be eligible for a fair-market value deduction. For a family that wants to continue doing the rescue work themselves, and have the bulk of their philanthropic dollars allocated to this task, an operating foundation might be the best fit to maintain the most control over the operations.

In order to convert, an existing private non-operating foundation can ask the IRS for reclassification as a private operating foundation. It must demonstrate it meets two tests designed to ensure that charitable activities are conducted actively (as opposed to passively through grant-making to other organizations): (1) an income test requiring that a specific amount of income be spent directly on the active conduct of the charitable mission and (2) one of three alternative tests regarding the foundation’s assets and revenues, called the asset, endowment, and support tests. Typically, this is examined over a four-year time horizon.

Changing the certificate of incorporation or a foundation’s trust instrument to permit operation of direct programs may also require judicial and/or state Attorney General approval. This ordinarily will have to occur before the operational changes that ultimately determine the appropriate tax status.

Case 3: Private operating foundation to private non-operating foundation

In a bit of a switch from the families we talked about in the first case study, consider a family that included a passionate collector of something of value—antique cars, sculptures, etc. The first generation might have originally set up their foundation as an operating foundation in order to start a museum to display the collection, only to find when they are ready to step back from day-to-day operations that their family is not interested in running the museum. This family may consider whether to convert their operating foundation to a non-operating foundation. In a case where a foundation’s assets are primarily illiquid, they would likely need to work with a specialty firm to liquidate the assets of the non-operating foundation as they convert, in order to meet their 5% distribution requirement.

If an organization is an operating foundation, it can choose in subsequent years to shift back to private non-operating foundation status. There is no penalty for converting back and forth, although it is necessary to comply with the rules that apply to the given status an organization has at the time. Donors will be especially sensitive to these changes if they are relying on the operating status as the basis for claiming a larger (i.e., fair market value) deduction or are concerned about the annual income limits on their charitable deductions. In addition to asking for the IRS to reclassify the foundation, legal counsel should review an organization’s governing documents to make sure that they do not limit the organization’s activities to grant making, or prohibit direct charitable activities.

Case 4: Private non-operating foundation to supporting organization of a public charity

In our final example, let us look at a family who created a private non-operating foundation so that the foundation could make grants to charities that support young people in the community who are aging out of the foster care system. Over the years, the family members running the foundation found
When there is a foundation—no pun intended—of mutual respect and appreciation for shared values, it is easier to have the conversation around the creation and periodic review of the family philanthropy enterprise.

themselves closely engaged with a public charity that implemented programs that strongly aligned with the values of the family’s non-operating foundation.

For a private foundation that supports only one organization (or one group of related organizations), a Type 1 supporting organization provides a useful middle ground. It preserves an institutional identity and a “place at the board table” for family members or other funders, at the same time as providing the tax benefits of public charity status.

The founder, family members, and family friends or advisors can fill seats on the board as long as the supported organization controls a majority of the remaining seats. An organization wishing to make the transition from private foundation status to supporting organization status ordinarily will follow the process outlined earlier for terminating its private foundation status and obtaining an advance ruling on its new status on IRS form 8940.

In conclusion
When there is a foundation—no pun intended—of mutual respect and appreciation for shared values, it is easier to have the conversation around the creation and periodic review of the family philanthropy enterprise. While the first generation may create a charitable vehicle with a specific purpose in mind, over time, the focus of the family’s philanthropy may shift. It is important to continually evaluate the intention, function, and structure of the family’s philanthropic enterprise, on both qualitative and quantitative levels, to ensure the enterprise is optimized for the family’s goals.

- Catherine McDermott, Senior Wealth Strategist, Advanced Planning
- Julie Binder, Senior Strategist, Family Advisory and Philanthropy Services

The Advanced Planning Group of UBS provides comprehensive planning, advice, and education to ultra high net worth individuals and families. The team consists of professionals with advanced degrees, extensive planning experience, and various areas of expertise. Through our publications, the Advanced Planning Group features the intellectual capital of UBS in wealth planning, estate tax, and philanthropy and evaluates how changes in the legislative and tax landscape might impact our clients’ planning.

The Family Advisory & Philanthropy Services team at UBS serves as a thought partner to exceptional families. We understand that families have needs that extend beyond the purely financial, so we take a strategic and sustainable approach to managing wealth for continuity. This team works with UBS Financial Advisors and their clients to clarify and articulate shared values and goals, bridge the gap between generations to perpetuate family legacy and develop a well thought out plan to support family goals, and philanthropic aspirations.

See important notes and disclosures on the next page.
1 For a comparison of private foundations and donor advised funds, please see our piece “DAFs and Private Foundations.”

2 The income tax charitable deduction for a gift of appreciated art or tangibles to a public charity or private operating foundation depends on whether the charity’s use of the gift is deemed “related” or “unrelated” to the charity’s charitable purpose. If the gift’s use is related, the donor is entitled to a deduction for the property’s fair market value, limited to 30% of her adjusted gross income. If the gift’s use is unrelated to the charity’s charitable purpose, the donor is only entitled to a deduction equal to her income tax basis in the property, limited to 50% of her adjusted gross income.

3 Excise taxes on private foundations were simplified by the 2020 Appropriations Act. Since 1969, private foundations have been subject to a two-tiered tax regime. Under the rules, the private foundation paid either a 1% or 2% tax on net investment income depending on the private foundation’s charitable expenditures. This dual regime is now eliminated, and the excise tax on net investment income for private foundations is changed to a single rate of 1.39%. This change is effective for tax years beginning after the date of the Act’s enactment (December 20, 2019).

4 In addition, excise taxes are imposed in connection with certain financial transactions or arrangements involving a private foundation. These are (1) taxes on “acts of self-dealing” between a private foundation and is disqualified persons; (2) taxes for failure to make a minimum annual payout for charitable purposes; (3) taxes on excess business holdings; (4) taxes on jeopardizing investments; and (5) taxes on certain types of prohibited grants and payments known as taxable expenditures, including payments for legislative lobbying or to influence the outcome of a public election, and certain types of grants to individuals. Public charities are not subject to these excise taxes, but are subject to other rules and excise taxes on excess benefit transactions between a disqualified person and the public charity.

5 Every supporting organization is categorized as Type I, Type II, or Type III, depending on the nature of its relationship with the supported organization. Each type of supporting organization has its own set of requirements and characteristics. Type II supporting organizations are comparatively rare in philanthropic contexts, where legal and tax practitioners typically focus on Types I and III. Intensified regulation of Type III supporting organizations, however, has made them less appealing in many circumstances.

6 If a private non-operating foundation fits the profile of a private operating foundation and believes it has met the private operating foundation tests and can continue to meet them, it should request IRS reclassification using Form 8940, Request for Miscellaneous Determination.

7 A foundation may qualify as a private operating foundation if it met the income test and either the asset, endowment, or support test for any three years during a four-year period, or based on a combination of relevant amounts of income or assets held, received, or distributed during the four-year period. The four-year period consists of the tax year in question and the three immediately preceding years. The private operating foundation must use the same computation method to satisfy the income test and one of the other three tests. Form 990-PF contains a section (Part XIV) that shows how the operating foundation tests and the timeline apply in actual practice.

8 A Type I supporting organization has a specific rule that states they must be “operated, supervised, or controlled by” its publicly supported organization. Due to the words “controlled by,” the relationship between the supported organization and the supporting organization is sometimes analogous to a “parent-subsidiary” relationship between corporations charitable structures. Our goal is to ensure that both the transfer and transition of wealth to a charitable vehicle are aligned in the way the wealth-creating generation envisions. Speak with your financial advisor about meeting with these two teams to discuss your objectives are from a legacy planning perspective, and we can help you identify the right vehicle or combination of vehicles for your situation or family.

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