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# Family Office Insights

## International Foundations – US Estate Planning Nightmare

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Today many global family offices use "international foundations" or "stiftungs" to hold, manage and distribute family investment assets for the benefit of family members. Foundations were originally formed in "civil law" jurisdictions including Liechtenstein, Switzerland and Panama.

Today, several "common law" jurisdictions, including the Cayman Islands, Jersey and in the US, the States of New Hampshire and Wyoming, have enacted laws to permit the formation of foundations. As explained below, because of US tax uncertainty concerning an "international foundation", these entities are not ideal for US taxpayers who have an interest in an "international foundation." In certain situations, other types of entities may be preferable if US persons are to be involved.

Our comments do not apply to US charitable foundations that are either corporations or trusts. The US tax considerations for both public foundations and private foundations are well defined, and the US Internal Revenue Service (IRS) has issued extensive substantive guidance on their administration and operation.

The key characteristics of "international foundations" are:

(i) Generally, an individual, often referred to as the founder, transfers specific assets to the foundation established by the founder for one or more specific purposes.

(ii) The founder appoints a person or persons to administer the foundation in accordance with the foundation's organization document, often referred to as its "charter." The charter sets forth the founder's retained powers, the authority and responsibilities of the administrators, as well as the discretionary or contingent interests of beneficiaries.

(iii) Generally, an "international foundation" manages investment assets and does not conduct an active or commercial business, although there are exceptions.

As noted above, there is some uncertainty as to the US tax treatment of an "international foundation" – it could be a trust or a corporation. The determination is based on the particular facts and circumstances of each foundation, and a foundation's charter can be drafted to include or exclude trust or corporate characteristics. Most foundations, especially those organized for managing family investments, are usually classified as trusts. If the foundation is determined to be a trust, further analysis is necessary to determine if the trust is either a US or a foreign trust-based on the "court" and "control" tests of the US tax regulations, and if the trust is either a grantor or non-grantor trust based on the US statutory provisions. The US tax compliance requirements differ significantly depending on the US classification of the foundation, and significant penalties could be imposed for either non-compliance or incorrect compliance. The foregoing appears to be straightforward so why is this a "nightmare".

As noted above, each "international foundation" must be examined to determine its US tax characterization. There is no automatic default rule, although most entities will be considered trusts.

Unfortunately, the IRS probably will not issue any advance guidance on this determination. US tax advisors will have to make this determination based only on their independent professional review of the facts and circumstances of each entity. The organization documents for many international foundations and their governing law are not written in English. Often those documents, as well as financial and transaction records of the foundation, will have to be translated into English for a US tax advisor to review them and determine the foundation's US tax classification. This determination will not be binding on the IRS.

US persons could have different financial or economic interests in an "international foundation". If the US individual is the foundation's founder, then the US individual could be considered the "grantor" of the trust and subject to the various special US income tax reporting, as well as possible transfer tax consequences of being the grantor of a trust. If the US individual is an administrator, then depending on the terms of the foundation's operative documents, the individual may have a general power of appointment depending on the control and discretion that could be exercised over the foundation. Finally, the US individual could be a "beneficiary" of the foundation. Again, the various special US income tax reporting and possible transfer tax consequences will need to be considered by the US individual. In addition, depending on the assets owned by the foundation with US beneficiaries, if the foundation owns interests in non-US corporations, partnerships or disregarded entities, special annual US income tax compliance obligations could apply often with current income tax consequences. Moreover, depending on the percentage interest of a US beneficiary in the foundation or the control that a US individual might have over the foundation, the US person could have additional US foreign bank account reporting obligations (referred to as "FBAR" compliance.)

In a recent case, a US individual formed a Stiftung, but had not been advised as to its US tax classification as a foreign grantor trust. This individual failed to file the appropriate annual US income tax reports and pay the appropriate US income taxes. Several years later he learned of this classification and his noncompliance. Ultimately, his estate was liable for substantial taxes, interest and penalties for his noncompliance.

For these reasons, US persons may be able to achieve greater US tax certainty concerning their US tax compliance obligations, if either a trust or a corporate entity is used instead of an "international foundation." If you have any questions or want to discuss the US tax considerations related to particular "international foundation", please consult your Squire Patton Boggs family office adviser or the author.

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