Article

United States: highlights of legal and tax differences of statutory foundations and private foundations

Lyubomir Georgiev*, Gregory Walsh†, Chelsea Hunter‡, Rebecca Lasky and Olga Sanders††**

Abstract

The article approaches the analysis of foundations primarily from an entity classification and tax point of view. First, the authors address the various options how a foreign foundation can be classified under U.S. tax law. Subsequently, the authors take a closer look at U.S. statutory foundations, which now exist under the laws of New Hampshire and Wyoming. In a third section, they explain the concept of a private foundation, which under U.S. federal tax law refers to a tax-exempt charitable organization. These private foundations are compared with statutory foundations with regard to their legal and tax law differences. The authors come to the conclusion that the ability to tailor a statutory foundation to meet specific needs using an entity with legal personality is very likely its greatest attribute that founders find attractive.

Introduction

From a U.S. tax perspective, a foundation, irrespective of where it is formed, can be treated as either a trust or as a business entity (which can be either a corporation or a partnership). A foundation's U.S. tax status, and thus its taxation, depends on the facts and circumstances, as discussed in this article.

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Foundations as trusts for succession purposes

A foundation would be treated as a "trust" for U.S. federal tax purposes if it is "an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or

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conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."[1] U.S. Treasury Regulations (the "Regulations"), which are enforced by the U.S. Internal Revenue Service (IRS), provide that *usually* "the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement."[2] The Regulations further clarify that in general

> an arrangement will be treated as a trust under the [U.S. Internal Revenue] Code if its purpose is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility, and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

For example, the IRS has concluded that a Liechtenstein foundation (Stiftung) is characterized as a trust because the Stiftung's primary purpose is to protect and conserve its assets.[3] If a foundation does not qualify as a trust, it will be treated as either a corporation or a partnership. As an example, Liechtenstein trust enterprise (trust reg.) is generally treated as a business entity for U.S. federal tax purposes because its primary purpose is to act as a business vehicle (similar to the Massachusetts business trust).

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Foundations as business trusts

A foundation would be treated as a business trust for U.S. federal tax purposes if it is similar to a trust but is primarily used to facilitate business operations. Arrangements known as trusts because legal title to property is conveyed to trustees for the benefit of beneficiaries, or technically cast in the form similar to a trust by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not be classified as trusts when they are *not* simply arrangements to protect or conserve the property for the beneficiaries.[4]

Foundations as investment trusts

A foundation would be treated as an investment trust for U.S. federal tax purposes if it is set up as a vehicle for investors to invest, historically, in corporate securities and other financial instruments, such as mortgage notes. An investment trust with a *single* class of ownership interests, representing undivided beneficial interests in the trust assets, will be classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders.[5] An investment trust with *multiple* classes of ownership interests, in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if it is formed to facilitate direct investment in the trust assets and the existence of multiple classes of ownership is incidental to that purpose.[6]

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Foundations as business entities

A foundation would be treated as a business entity for U.S. federal tax purposes if it is "not properly classified as a trust under [the Regulations], or otherwise subject to

1. See Treas. Reg. § 301.7701-4(a).
2. Ibid.
3. See IRS Chief Counsel Advice Memorandum dated 7 October 2009, which did not address the proper U.S. tax status if the Stiftung had a different primary purpose (ie, other than to protect and conserve assets).
4. See Treas. Reg. § 301.7701-4(b).
5. See Treas. Reg. § 301.7701-4(c).
6. Ibid.

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special treatment under the Internal Revenue Code."[7] A foundation classified as a business entity will be treated as "domestic" if it is created or organized under the laws of the United States (federal law) or the laws of any U.S. State, and as "foreign" when it is not domestic.

An "eligible"[8] business entity can elect its classification for U.S. federal tax purposes, and if it has two or more owner-members that can be classified as either a partnership or corporation for U.S. tax purposes. The default classification (without any election) of a foreign foundation that is a business entity for U.S. federal tax purposes is based on the number of members of the foreign entity and whether they have limited or unlimited liability.[9] If the foreign entity has two or more owner-members and at least one owner-member does not have limited liability, the default classification is a partnership. If all owner-members of the foreign entity have limited liability, the entity will be classified as a corporation for U.S. federal tax purposes. In addition, if the foreign entity has a single owner-member, and the owner has unlimited liability, the foreign entity will be classified as an entity that is disregarded as separate from its sole owner (a "disregarded entity").

Distinguishing between foundation as trust and as business entity

The determination of whether a foundation should be treated as a trust or business entity for U.S. tax purposes depends on (i) whether there was an objective to carry on business and divide the gains thereof and (ii) whether there were "associates."[10]

A foundation formally cast as a foundation but run by associates as a "business for profit" will be considered a business entity for U.S. federal tax purposes.[11] The Regulations do not define the phrase "business for profit." However, U.S. courts have held that determining whether an entity such as trust (or foundation) has a business objective is based on (i) the express terms of its organizing document[12] and (ii) the purpose for which it is organized.[13] Accordingly, even if the members intended to act within a narrow scope to preserve property but the documents provide for broader authority, then the broader purpose will be given effect as the objective.[14]

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At a high-level, "associates" refers to those persons who: (i) have a beneficial interest in the profits of the enterprise and (ii) voluntarily participate in the enterprise.[15] In other words, if the beneficiary of an enterprise becomes associated with the enterprise of their own volition, then they will be considered associates and the entity will be held to have associates for purposes of U.S. federal tax classification. Courts have noted that the following factors suggest beneficiaries are not associates:

1. they played no role in the entity's creation,
2. their influence or participation in the entity was limited, and
3. their interests were not transferable.[16]

A Liechtenstein establishment (Anstalt), for example, is generally treated as a business entity from a U.S.

7. See Treas. Reg. § 301.7701-2(a).
8. An "eligible" entity is a business entity that is not classified as a "per se" corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7) or (8).
9. See Treas. Reg. § 301.7701-3(b)(2).
10. See Treas. Reg. § 301.7701-2(a)(2); Elm Street Realty Trust v. Commissioner, 76 T.C. 803 (1981), acq., 1981-2 C.B. 1.
11. See Treas. Reg. § 301.7701-4.
12. See *Elm Street Realty Trust*, at 810–11.
13. *Helvering v. Coleman-Gilbert Associates*, 296 U.S. 369, 373 (1935).
14. As an example, in *Elm Street Realty Trust*, the Tax Court found that the trust had a business objective when "the trustee's powers were in no way limited merely to conserving and protecting" the property for the beneficiaries. The declaration of trust stated that the trustee had "complete control, management and power to invest and reinvest the Trust property in any manner he may deem advisable and in any kind of property" and "to purchase or sell any property of any character." In that case, the court held that the trustee's powers were not limited to protecting the trust property for the beneficiaries, but went beyond the typical duties of a trustee of an ordinary trust.
15. See *Morrissey v. Commissioner*, 296 U.S. at 356–57.
16. See *Elm Street Realty Trust*, at 817–18.

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federal tax perspective; however, the ultimate conclusion still depends on an analysis of all the relevant facts and circumstances.

Statutory foundations

A "statutory foundation" is a separate legal entity formed under U.S. State law that can operate as a business entity or a trust.

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Private non-charitable foundations were originally developed in civil law jurisdictions, many of which do not recognize the concept of trusts or have difficulty classifying them for local law purposes. Two U.S. States (New Hampshire and Wyoming) have so far adopted common law foundation legislation.[17] While the two statutes differ in many respects,[18] both allow foundations to be

- created for one or more lawful purposes, which may include a charitable and/or non-charitable purpose, and
- designed with broad flexibility consistent with the family's needs and objectives.

Similar to corporations, a statutory foundation has legal personality and exists distinct from its founders, directors, and beneficiaries. This allows the foundation to hold assets independently, unlike a trust where legal title to the assets is vested in the trustee. The foundation may function in a manner similar to a trust depending on the terms of the foundation's governing documents, which define the relevant rights, interests, and powers of the beneficiaries. Alternatively, the foundation may be designed to operate in a manner similar to a corporation or limited liability company, with directors owing duties primarily to the foundation, and beneficiaries (if any) having limited or no rights to interfere with the foundation's management or the directors' discretion. If desired, the foundation may instead be designed primarily for charitable purposes, akin to a charitable trust or charitable private foundation (without the benefit of tax-exempt status).

In addition to the legal personality and fluid structure of statutory foundations, there are several other key benefits. Both of the currently effective statutes generally provide asset protection for property that is transferred to the foundation, which in most cases cannot be reached by creditors, except for example in the case of a fraudulent transfer. Directors and protectors of statutory foundations are generally afforded limited liability. Thus, the foundation's debts, obligations, and liabilities are solely those of the foundation and parties will not be held personally liable, except where such persons breach the applicable threshold for liability (e.g., fraud, willful misconduct). The flexibility allows family members to have more significant participation in the foundation's governance and a greater degree of control over the foundation's assets, if desired and consistent with the foundation's purpose.

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A statutory foundation may be used as a holding vehicle, for example as a shareholder of a corporation, a member of a limited liability company, or a partner of a partnership. It can also act as a protector or beneficiary of a trust, hold shares of a private trust company, or even act as a private trust company. The foundation may also hold a variety of family assets, including substantial business assets, which are often impractical to hold in a trust. Unlike trusts formed in many U.S. States, a statutory foundation formed in either New Hampshire or Wyoming may exist virtually in perpetuity.

17. The New Hampshire Foundation Act, effective 1 October 2017 (N.H. RSA 564-F), and the Wyoming Statutory Foundation Act, effective 1 July 2019 (Wyo. Stat. Title 17, Ch. 30).

18. See Todd D Mayo, Amy M Staehr & Von Sanborn, "US-situs foundations" (July 2021) 27 (6) Trusts & Trustees (2021) 584–95, for a detailed discussion of these statutes.

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Absent definitive guidance, the U.S. federal tax treatment of a statutory foundation must be determined on a case-by-case basis. There is some precedent for treating civil law foundations established under the law of foreign jurisdictions as trusts when they are set up for preserving property for beneficiaries and not engaged in commercial activities.[19] In general, the existing framework for entity classification under the Regulations, as outlined above, applies to determine the tax classification. Accordingly, if a statutory foundation is considered to be conducted by associates as a "business for profit," it will be classified as a business entity. If instead the foundation is viewed as an arrangement to protect or conserve property for beneficiaries, it will be classified as a trust.

The U.S. tax analysis will generally depend on the terms of a statutory foundation's governing documents. Their provisions should be carefully drafted to ensure the intended tax treatment.[20] If business entity treatment is desired, the foundation should be designed to carry on a profit-making business that normally would be carried on through a corporation or partnership. In particular, beneficiaries should be given a defined (and ideally, transferable) interest in the foundation.

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If trust treatment is desired for U.S. federal tax purposes, the foundation should be designed to hold and manage assets for the benefit of beneficiaries, and should be prohibited from conducting business activities. The nature of the beneficiaries' interests should be akin to those of trust beneficiaries, and the duties of the foundation's directors should be akin to those of trustees under the applicable state law. If treated as a trust, the foundation may be (i) either a grantor trust or non-grantor trust and (ii) a domestic trust or foreign trust, for U.S. federal income tax purposes; corresponding provisions should be included in the foundation's operating agreement to achieve the desired result.[21]

A key disadvantage of forming a U.S. statutory foundation is that it has largely been untested. Applicable U.S. State and U.S. federal law interpreting and governing statutory foundations is either limited or nonexistent. It is unclear how courts will rule on matters involving such entities. In contrast, trusts, for example, have a long-standing history in the United States and trust law is highly developed. Consequently, as is true for wealth planning vehicles generally, statutory foundations are appropriate to consider for certain founders in certain situations.

Private foundations (U.S. tax exempt)

A statutory foundation should not be confused with a private foundation for U.S. federal tax purposes. "Private foundation" is a term of art used in U.S. federal tax law to describe a certain type of tax-exempt charitable organization. There are several types of organizations that may be treated as tax-exempt in the United States.

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To receive tax-exempt treatment as a charitable organization, an entity

- must be organized and operated *exclusively* for religious, charitable, scientific, literary, or educational purposes and may not benefit private interests[22];
- may not engage in any political activities;

19. *See Estate of Swan v. Commissioner*, 247 F.2d 144 (2d Cir. 1957).
20. It may also somewhat depend on the state legislation under which a statutory foundation is formed; the New Hampshire statute is more conducive to trust treatment, whereas the Wyoming statute is more flexible in allowing for either a trust or business entity. See, eg Mayo et al., note 19, at 594–95.
21. For example, if a foreign grantor trust is desired, a non-U.S. founder may be given the power to "revoke" the foundation.

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- must limit its legislative activities, if any, to the allowable level; and
- must apply to the IRS to formally recognize its tax-exempt status (with exception for certain foreign charities).[23]

Entities exempt as charitable organizations are classified as either "private foundations" or "public charities." While the rules are complex and technical, the entity will generally be treated as a "public charity" if it receives more than one-third of its support from the general public (including the government).[24] A donation is deemed to be from a member of the "general public" if the amount in a given year does not exceed a certain threshold. If an entity does not receive more than one-third of its support from members of the general public, it is classified as a "private foundation." There are exceptions to this rule for certain educational institutions, hospitals, churches, and organizations that receive funds from their charitable operations. In contrast, an exempt charitable organization funded by a single individual, a family, or a single corporation, or by only a few donors would typically be classified as a private foundation.

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Classification of an organization as a public charity or private foundation is *solely* for U.S. tax purposes. As such, an organization formed under local law as a corporation, foundation, trust, unincorporated association, or limited liability company will be either a public charity or private foundation for U.S. tax purposes depending upon the above criteria.

Private foundations are subject to additional documentary and operational requirements under U.S. tax law for transparency purposes because they are often run by their founders. Private foundations must include a number of special technical and complex provisions in their governing documents, including in the certificate of formation, bylaws, trust agreement, etc.[25] In general, the governing documents must include prohibitions against—

i. self-dealing between the private foundation and its founders, managers and their families and entities they own,
ii. holding more than allowable percentages of active businesses ("excess business holdings"),
iii. making investments that could jeopardize accomplishing its charitable purposes, and
iv. making "taxable expenditures," such as lobbying, political activities, and making non-compliant grants to individuals and organizations.

The governing documents must also include a provision requiring the private foundation to distribute at least 5% of its assets for exempt purposes annually ("minimum distribution requirement"). If an entity does not operate in compliance with these requirements, it will be subject to penalties and may eventually lose its U.S. tax exemption.

Private foundations must submit an annual report on IRS Form 990-PF reflecting their operations and compliance with the exemption requirements to the IRS. If an entity terminates its status as a private foundation, it would owe a termination tax equal to the value of all tax benefits it has received, up to the amount of its remaining assets. U.S. private foundations are also subject to an excise tax of 1.39% on their net investment income.

The additional requirements mentioned above for private foundations do not apply to foreign charities (including those formed as foundations) that receive at least 85% of their funding from persons who are not U.S. tax residents.[26] Such foreign funded charities

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22. Code Section 501(c)(3).
23. Code Section 508(a).
24. Code Section 509(a).
25. Code Section 508(e).
26. Code Section 4948(b).

qualify for U.S. tax exemption as long as they are organized and operated *exclusively* for religious, charitable, scientific, literary, or educational purposes and are not benefitting private interests. They are not required to apply to the IRS for a formal recognition of their tax-exempt status and are not subject to a termination tax.

A registered foreign-funded charity that receives more than one-third of its support from members of the public would generally be classified as a public charity for U.S. tax law purposes. In contrast, if a foreign charity is funded by an individual, a family, or a corporation, then the charity would fail the public support test and would be classified as a foreign private foundation. Foreign charities classified as private foundations are subject to an excise tax of 4% on their U.S.-source gross investment income.[27]

There is a mechanism for foreign tax-exempt organizations classified as public charities to claim exemption from withholding and for foreign private foundations to claim a 4% withholding rate on their U.S. source investment income.[28] The entity can claim tax-exempt status on IRS Form W-8EXP, *Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding*. The entity must attach either a favorable determination letter from the IRS recognizing its tax-exempt status or a legal opinion by U.S. counsel concluding that the entity is described in Code Section 501(c)(3). U.S. counsel rendering such a legal opinion would review the governing documents, operations and reports of the entity. The entity must certify on IRS Form W-8EXP whether it is a private foundation or not. If the entity claims that it is *not* a private foundation, it must furnish an affidavit setting forth sufficient facts for the IRS to make a determination. Alternatively, if the entity is classified as a private foundation, it would be subject to a 4% withholding tax on its gross investment income.

The entity can claim tax-exempt status on IRS Form W-8EXP, Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding

Both public charities and private foundations are taxed on certain income generated from businesses unrelated to their exempt purposes ("unrelated business taxable income", or UBTI).[29] The foreign tax-exempt entity must specify on IRS Form W-8EXP whether any of its U.S. source income is UBTI, which will be subject to U.S. taxation (on the income effectively connected to the United States).

In addition to tax benefits for the entities described in Code Section 501(c)(3), U.S. donors may be able to receive income tax deductions in respect of their contributions to these entities. With some exceptions, more generous deductions are available to donors to public charities as compared to donors to private foundations. However, no income tax charitable deduction is available to U. S. donors to a foreign charity (i.e., an organization formed under laws other than the laws of the United States), regardless of whether such charity may be treated as a public charity or private foundation. Notably, an income tax deduction to a donor is generally available if a charitable corporation is formed in the United States but is engaged in foreign operations.

To raise funds from U.S. donors, foreign charities often use "friends of" organizations formed in the United States. U.S. donors typically make tax-deductible contributions to the "friends of" organization, which in turn makes grants to foreign charities. However, the "friends of" organization may not act as a mere conduit and must have sufficient discretion as to how the funds are distributed.[30]

27. Code Section 4948(a).
28. Treas. Reg. § 1.1441-9; IRS Form W-8EXP. Generally, persons who are not U.S. tax residents are subject to a 30% withholding rate on their U.S. source income (unless they can claim a lower rate under an income tax treaty). Code Section 871.
29. Code Section 512.
30. Rev. Rul. 63-252.

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The "friends of" organization may not act as a mere conduit and must have sufficient discretion as to how the funds are distributed

If a "friends of" organization is classified as a private foundation, its grant-making procedures will be subject to additional requirements to ensure that grants to foreign organizations are not treated as taxable expenditures subject to excise taxes. Private foundations making grants to foreign organizations must

1. either obtain a legal opinion concluding the foreign organization is equivalent to a public charity or
2. all grants must be subject to the "expenditure responsibility" requirements,[31] including procedures for identifying a grantee and a written grant agreement obligating the grantee to submit periodic reports to the grantor and to return grant funds under some circumstances; the grantor private foundation must report the grant and spending thereunder to the IRS on its annual return on IRS Form 990-PF.

Unlike income tax benefits, gift, and estate tax charitable deductions are available to U.S. donors to non-U.S. charities described in Code Section 501(c)(3).[32] To qualify for a deduction, such non-U.S. charity must either apply to the IRS for recognition of its tax-exempt status or be at least 85% foreign funded.

Conclusion

The ability to tailor a statutory foundation to meet specific needs using an entity with legal personality is very likely its greatest attribute that founders find attractive. Its governing provisions should be drafted properly taking into account all non-tax succession requirements as well as the intended tax treatment. The determination of whether the foundation should be treated as a trust or business entity for U.S. tax purposes is based on analysis of the specific facts and circumstances as well as its administration. The primary objective can generally be either to protect and conserve its assets (as a trust) or to carry on a business and divide the income and gains (as a business entity). Separately, the classification of an entity (including a foundation or a trust) to be tax exempt as a private foundation or a public charity is based on complex and technical requirements and its funding sources but is relevant solely for U.S. tax purposes.

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31. Treas. Reg. § 53.4945-5.
32. Code Sections 2055(a); 2522.

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