

INSIGHT: The New Hampshire Foundation Act: A Solid Foundation for Wealth Management on a Global Scale

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Thanda Brassard of Fiduciary Trust Co. of New England, Steven Burke of McLane Middleton, Von Sanborn of Day Pitney, and Constance Shields of Withers Bergman discuss the New Hampshire Foundation Act. The authors say the act presents opportunities not previously available in the U.S. for wealth management and asset protection for clients from civil law jurisdictions.

New Hampshire recently signaled its intention to be one of the leading states for fiduciaries to consider by enacting The New Hampshire Foundation Act, making it the first state to permit the establishment of civil law foundations. Generally, foundations are legal entities similar to trusts, but foundations also have features similar to that of corporations and limited liability companies. Foundations have long been popular across Europe and parts of Asia, in countries as diverse as Malaysia, Austria, Malta, Luxembourg, the Netherlands, and Estonia. Many of these civil law countries do not recognize trusts or have difficulty classifying them for local law purposes.

Thanks to New Hampshire legislators, advisors now have the option to use a New Hampshire-based foundation as a wealth management tool for clients residing in civil law jurisdictions. Based on ease of use in the international arena and likely favorable tax treatment and asset protection potential, foundations are a wealth management game-changer in the U.S. and potentially internationally. This article discusses the benefits, structure, and taxation of foundations, and concludes with scenarios in which they may be beneficial to clients and their advisors.

THE USES AND BENEFITS OF NEW HAMPSHIRE FOUNDATIONS

For non-U.S. individuals residing in civil law jurisdictions, some of whom may have established off-shore foundations already, a foundation created under the act is a familiar structure, and one that their taxing authorities should recognize and understand. Moreover, non-U.S. individuals unaccustomed to granting an institutional trustee complete control over their assets may be more comfortable with a foundation because of its formalized corporate governance structure. The drafters of the act clearly contemplated such a scenario. The act deals specifically with non-U.S. foundations and their domestication and operation in New Hampshire (*See N.H. Revised Statutes Section 564-F:21-2102, et. seq.*).

While perhaps most appealing to international clients looking to on-shore their wealth management structures to the U.S., a foundation may also be attractive to domestic clients because it combines elements of trusts and corporations. The act borrows components from the New Hampshire Trust Code, Business Corporations Act, and Revised Limited Liability Company Act. The rights and duties of the founders, directors, and beneficiaries, for example, are based on established trust law, as is the process for modifying and reforming a foundation's governing documents.

Likewise, the act's establishment of the New Hampshire Circuit Court, Probate Division as the court of jurisdiction for disputes regarding foundations solidly grounds New Hampshire foundations in trust law. At the same time, the procedural rules governing the formation, registration, and dissolution of a foundation have their genesis in corporate law; as do the duties of good faith, loyalty, impartiality, and prudent judgment required of foundation directors. By combining trust and corporate principles in this unique way, foundations give clients the ability to establish a "best of both worlds" entity that many will find attractive.

Importantly, a foundation may be a particularly good candidate for those clients looking to establish a private trust company that offers wealth management services exclusively for their families. Under New Hampshire's Family Trust Company Act, a private trust company may provide trust, investment, and related services to a family (N.H. Rev. Stat. Sections 383-D:3-301, 564-F:8-802). With its corporate structure and formalized governance, but no shareholders, a foundation may be the ideal legal form for such a company.

Like corporations, foundations are meant to be separate legal entities from their founders, directors, and beneficiaries. This allows a foundation to hold its assets independently, unlike a trust where the assets are vested in the trustee. It also means a foundation has the capacity to sue and be sued. Foundations are also allowed to have virtually perpetual existence and not be subject to certain state perpetuities restrictions applicable to trusts.

Foundations also allow for limited liability for founders, directors, and beneficiaries. The act explicitly states that the foundation's debts, obligations, and liabilities are solely those of the foundation; and that the founders, foundation officials, and beneficiaries will not be held personally liable (N.H. Rev. Stat. Section 564-F:15-1501). By contrast, a trustee, while generally protected, faces potentially unlimited liability for certain acts and, depending on the trust structure and applicable governing laws, trust assets may be reached by a beneficiary's creditors. From an asset protection standpoint, under the right conditions, a foundation can be a very attractive trust alternative.

Although a foundation may provide a number of advantages, they are not without disadvantages. Most importantly, applicable state and federal law interpreting and governing foundations is either limited or non-existent, and the act remains largely untested. Accordingly, while non-U.S. clients familiar with foundations may be attracted to them, clients (and their advisors) based in the U.S. or other common law jurisdictions may gravitate towards trusts. As with most wealth planning vehicles, foundations will not be for every client in every situation. For example, for a client looking to transfer a commercial business, a trust would likely be preferable to a foundation because transferring a commercial entity to a foundation might cause taxing authorities to treat it as a corporate entity, rather than a trust, eliminating its favorable tax status (see Taxation of Civil Foundations, below).

THE NUTS AND BOLTS OF FOUNDATIONS

A “foundation” is a legal entity that holds and manages its assets for its beneficiaries in a manner consistent with the foundation’s expressly stated purpose. If that sounds familiar, it is because a foundation feels and acts much like a trust. The act combines elements of New Hampshire’s robust trust laws (especially in defining the rights and duties of the founders, beneficiaries, directors, and protectors) with New Hampshire’s well-thought out corporate and limited liability company laws to create an entity that acts like a trust but “looks like” (i.e., takes the form of) a corporation.

Foundation Parties

The parties to a foundation are its founder, organizer, directors, and beneficiaries. A “founder” is the person who, like the donor of a trust, contributes property to the entity (See N.H. Rev. Stat. Section 564-F:2-201(l)). If more than one person contributes property to a foundation, then each is a founder with respect to the portion of the property attributable to his or her contribution, except to the extent that another person has the power to revoke or withdraw that portion. Like the donor of a revocable trust, a founder also has (unless the governing documents provide otherwise) the power to amend the foundation’s certificate of formation, to amend or revoke its bylaws, to direct the directors to make distributions, and to dissolve the foundation (N.H. Rev. Stat. Section 564-F:7-702). The certificate of formation or bylaws may, however, modify or waive the powers of the founder (as is the case in many irrevocable trusts) (N.H. Rev. Stat. Sections 564-F:7-702, 564-F:7-703). A founder does not acquire any right, power, or interest in a foundation solely by reason of contributing property to the foundation; rather, the founder’s powers are set forth (or explicitly restricted) in the governing documents (See N.H. Rev. Stat. Section 564-F:9-901(c)).

The organizer is the person who signs and files the foundation’s certificate of formation with the New Hampshire Secretary of State. This filing forms the foundation (N.H. Rev. Stat. Section 564-F:3-301). The organizer can be a founder, director, or any other person acting on behalf of the founder or directors, and may be an individual or an entity.

A foundation must have a board of directors (N.H. Rev. Stat. Section 564-F:10-1001). A foundation’s board of directors is vested with the power to manage the foundation and its affairs. Foundation directors are similar to the trustees of a trust. Directors, who may be either individuals or entities, must initially be appointed by the organizers or the founder (N.H. Rev. Stat. Section 564-F:10-1005; see N.H. Rev. Stat. Section 564-F:2-201(g)). Subsequent directors are generally required to be appointed in accordance with the foundation’s governing documents (N.H. Rev. Stat. Section 564-F:10-1005). Importantly, a director of a New Hampshire foundation is not required to be a New Hampshire resident or even a U.S. citizen (N.H. Rev. Stat. Sections 564-F:2-201(q), 564-F:10-1002), which gives greater flexibility to foundations as a means of managing wealth on a global scale by residents of various countries.

The directors may establish committees and delegate their powers (See N.H. Rev. Stat. Sections 564-F:10-1008, 564-F:10-1009). A foundation may also have one or more classes of directors who have different powers and duties, which is somewhat analogous to a directed trust. Directors must manage the foundation's property for the benefit of its beneficiaries and in furtherance of the foundation's purposes (See N.H. Rev. Stat. Section 564-F:11-1101). Moreover, a foundation's directors have a non-waivable duty to manage the foundation and its property in good faith and in accordance with the terms of the foundation's bylaws, certificate of organization, and the act. Directors have duties akin to those of a trustee, which include duties of loyalty, impartiality, prudent management; and duties to inform qualified beneficiaries about the foundation's affairs and property, maintain its books, and to prudently manage, control and protect foundation property (See N.H. Rev. Stat. Sections 564-F:11-1101 through 564-F:11-1107).

A foundation may also have one or more protectors, whose powers and duties are set forth in the certificate of formation and the bylaws (N.H. Rev. Stat. Section 564-F:12-1201). A protector may be an individual or an entity, and does not have to be a New Hampshire resident (N.H. Rev. Stat. Section 564-F:12-1202(b)). Like trust protectors, foundation protectors are tasked with protecting the foundation and enforcing its governing documents when necessary (See N.H. Rev. Stat. Section 564-F:12-1201(c)).

Notably, a beneficiary of a foundation must be identifiable by name, as a member of an ascertainable class of persons, or by relationship to another person (N.H. Rev. Stat. Section 564-F:2-201(a)). Like a trust beneficiary, a foundation beneficiary's interest is usually a mere expectancy, rather than a vested property right in the foundation or its assets except (1) to the extent that the beneficiary has a currently exercisable power of withdrawal, or (2) to the extent of an undistributed mandatory distribution (N.H. Rev. Stat. Section 564-F:14-1401). For purposes of determining a beneficiary's interest, the founder's intent as expressed in the terms of the governing documents is paramount.

Governing Documents

The documents that govern the management and organization of a foundation are its certificate of formation and bylaws. The certificate of formation must contain (1) the foundation's name, which must contain "foundation," "stichting" (the Dutch term for a foundation), or the abbreviation "fnd." or "stak."; (2) the identity of the registered agent in New Hampshire; (3) a New Hampshire office address; and (4) the organizer's name and signature (See N.H. Rev. Stat. Sections 564-F:3-301, 564-F:4-401). The certificate of formation may also state the foundation's purpose, directors, effective date, termination date, and provisions regarding the management of the foundation and restrictions on the duties and powers of the foundation (See N.H. Rev. Stat. Section 564-F:3-301(c)).

The founder, organizers, or initial directors adopt the foundation's initial bylaws, which must state the purpose of the foundation (N.H. Rev. Stat. Sections 564-F:7-701(a), 564-F:7-701(b)). Each purpose, whether charitable or non-charitable, must be lawful, not contrary to public policy, and possible to achieve (N.H. Rev. Stat. Sections 564-F:6-601(b), 564-F:6-601(c)). A foundation may act as a private trust company, and this could be a purpose of the foundation.

Sometimes the bylaws also contain restrictions on a founder's rights, interests, and powers. Bylaws may also contain restrictions on distributions from the foundation property to beneficiaries, capital contributions (note that there is no minimum capital requirement for a foundation) (See N.H. Rev. Stat. Section 564-F:9-901), or the use or application of foundation property (N.H. Rev. Stat. Section 564-F:7-701(c)). Finally, bylaws sometimes include no-contest clauses and provisions regarding nonjudicial resolution of disputes (N.H. Rev. Stat. Sections 564-F:7-701(c)(9), 564-F:7-701(c)(10), 564-F:14-1404).

Although the probate court has jurisdiction over the modification, reformation, or termination of a foundation and any claim by a beneficiary against a director or protector for a breach of a specific duty, the bylaws may require any dispute to be resolved in accordance with reasonable nonjudicial dispute resolution procedures (N.H. Rev. Stat. Sections 564-F:16-1601 through 564-F:16-1607). However, if a dispute addresses whether (1) a foundation's formation was valid, (2) a contribution by a founder to the foundation was valid, or (3) any particular purpose is a material purpose of the foundation, only the probate court can decide the issue (N.H. Rev. Stat. Section 564-F:16-1607(a)(2)).

TAXATION OF NEW HAMPSHIRE FOUNDATIONS

The creation of civil foundations under state law raises the question of how they will be taxed under federal and state tax law. Although foundations were intended to be part trust and part corporation, the hope and expectation is that, for both federal and state income tax purposes, foundations will be treated as trusts. New Hampshire statutes have been updated to clarify tax treatment for foundations. In amending its tax laws, New Hampshire's legislature provided foundations with the same favorable tax treatment it grants to trusts. This is a significant benefit, as it means that foundations will generally avoid tax at the state level. Federal statutes, on the other hand, make no specific provision for civil foundations, so their tax treatment must be determined under the existing general regulatory framework for entity classification.

Federal Income Taxation of a New Hampshire Foundation

An initial determination must be made as to whether a New Hampshire foundation is a "business entity" or a "trust" within the meaning of the Internal Revenue Code (See Treasury Regulation Sections 301.7701-1(b), 301.7701-2(a)). Neither of these terms are simple to define at first glance. Generally, "business entity" is defined by Treasury Regulations as an entity recognized for federal tax purposes that is **not** classified as a trust or otherwise subject to special treatment under the Internal Revenue Code. If a business entity is not a trust, it is taxable as a corporation or partnership, or it is disregarded for federal tax purposes.

The Treasury Regulations provide that a "trust" is an arrangement created either by will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the rules applied in chancery or probate courts. The definition of a "trust" generally excludes so-called business trusts and investment trusts, which, though nominally trusts, are more properly treated as business entities.

Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in the 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 a business for profit. The beneficiaries of a trust typically do no more than accept benefits from the trust and are not the creators of the trust arrangement (Treas. Reg. Section 301.7701-4(a)).

That being said, not all arrangements in which title is delivered to a trust for the benefit of one or more beneficiaries are trusts for federal tax purposes. If the arrangement is created by the beneficiaries as a device to carry on a profit-making business that normally would be carried on through a corporation or partnership, the entity is more properly characterized as a business trust, taxable as a business entity, and classified as a corporation, partnership, or disregarded entity (*See* Treas. Reg. Section 301.7701-4(b)). The Treasury Regulations also except investment trusts from the definition of a trust. An investment trust is not classified as a trust for federal income tax purposes if there is a power under the trust agreement to vary the investment of the certificate holders (Treas. Reg. Section 301.7701-4(c)). Such a trust is also taxable as a business entity.

Entities properly classified as trusts are further classified as either grantor trusts or nongrantor trusts. Under I.R.C. Sections 671 through 679, two kinds of domestic trusts are treated as grantor trusts: trusts whose beneficiaries have a right to demand corpus or income and trusts where the grantor retains specified powers or interests or grants them to those statutorily deemed to be under the grantor's control. Power and interests that can have this result include retained reversionary interests, direct or potential beneficial interests in trust income, powers to revoke the trust and recover the trust corpus, certain retained powers over the distribution of trust income or corpus, certain retained administrative powers, the authority to borrow trust funds without adequate interest and security, or actual borrowing of trust funds without adequate interest and security approved by an independent trustee.

The income, deductions, and certain other items of a grantor trust must be reported on the return of the person(s) who is treated under the Internal Revenue Code and Treasury Regulations as owning the grantor trust (or portions thereof) (I.R.C. Section 671). Notably, this result may be an undesirable outcome for a non-U.S. individual hoping to avoid personal U.S. tax filing obligations. A nongrantor trust on the other hand files its own return and is taxable as a simple trust under I.R.C. Sections 651 and 652 or a complex trust under I.R.C. Sections 661 through 663.

Application of the Federal Entity Classification Framework to New Hampshire Foundations

Even if New Hampshire law treats foundations as trusts, federal taxing authorities will examine each particular New Hampshire foundation under the framework described above, and results will vary depending on the particular facts and circumstances. Commentators have pointed out that a close, literal reading of the Treasury Regulations does not reliably predict the classification of entities, including New Hampshire foundations, as trusts or business entities.

The essence of the test as applied by the courts is whether the entity is authorized to, or does in fact, carry on active business operations, and the extent to which the entity provides opportunities for investors to work together voluntarily in the pursuit of a profit objective. Courts usually find that a trust is taxable as a business entity where the “beneficiaries” are associates with an objective of carrying on a business and sharing profits therefrom.

While the treatment of New Hampshire foundations is necessarily based on a facts and circumstances analysis, there is some precedent for treating civil law foundations established under the law of non-U.S. jurisdictions as trusts. For example, in *Estate of Swan*, the U.S. Court of Appeals for the Second Circuit considered the nature of family foundations established under Swiss and Lichtenstein law. The court rejected the taxpayer’s position that the foundations were taxable as corporations, and concluded that transfers to the foundations were more like transfers to revocable (i.e., grantor) trusts because of the decedent’s power to alter, amend, and revoke such transfers pursuant to the foundation’s governing documents. This holding suggests that absent the power of reversion, the family foundation in *Estate of Swan* would have been treated as a non-grantor trust.

Furthermore, the default provisions of a New Hampshire foundation arguably describe a trust under federal tax law. A foundation is a legal entity that can be designed to hold and manage assets for the benefit of beneficiaries, which is analogous to a trust. A foundation is a legal entity with its own powers (unlike a trust), but a foundation’s directors are roughly equivalent to trustees (N.H. Rev. Stat. Sections 564-F:8-801 to 564-F:8-802). Further, its directors have duties loosely based on the New Hampshire Trust Code.

Importantly, the duties of a foundation’s directors, unless the bylaws provide otherwise, include a duty to control and protect foundation property, which arguably meets the requirement of Treas. Reg. Section 301.7701-4(a) that a trust have “trustees” who “take title to property for the purpose of protecting or conserving it for the beneficiaries” (N.H. Rev. Stat. Section 564-F:11-1105). Finally, like a trust, a foundation does not issue shares or membership interests in exchange for contributions to capital (See N.H. Rev. Stat. Section 564-F:9-901).

Based on the foregoing, it seems likely that a New Hampshire foundation can be designed to be treated as a trust under the Internal Revenue Code: the purpose of the foundation can be to vest in the directors 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 a business for profit. Provided that the powers and interests triggering grantor trust treatment are not granted to beneficiaries or founders, it should also be possible to escape grantor trust treatment when necessary.

New Hampshire Taxation

The tax treatment of New Hampshire foundations is established by statute. The relevant New Hampshire statutes have been amended to provide that foundations are taxable in the same manner as trusts. These statutes generally require a two-step analysis to determine whether (1) the foundation is treated as a grantor trust under I.R.C. Section 671; and (2) all or a portion of the foundation’s income is apportionable to New Hampshire (See N.H. Rev. Stat. Sections 77:10, 77-A:1, 77-E:1).

Interest and Dividends Tax

Interest and dividends payable to a New Hampshire foundation are not subject to New Hampshire tax on the foundation itself; however, they are taxable to certain founders and beneficiaries of the foundation. Specifically, interest and dividend income received by a foundation **treated as a grantor trust** under I.R.C. Section 671 is required to be reported on the return of the grantor to the extent that the grantor is a resident of New Hampshire (See N.H. Rev. Stat. Section 77:10). The statute is silent as to how a trust treated as owned by its beneficiaries under I.R.C. Section 678 is treated. By analogy, such beneficiaries would likely need to report foundation income on their personal returns.

Interest and dividends actually paid by a New Hampshire foundation that is *not treated as a grantor trust* under the Internal Revenue Code to a beneficiary who is a resident in New Hampshire is included as interest or dividends in the return of the beneficiary.

New Hampshire Business Taxes

Foundations that carry on business activity in New Hampshire may be subject to New Hampshire's business profits tax (BPT) and business enterprise tax (BET). The BPT is imposed on taxable business profits of every "business organization" (N.H. Rev. Stat. Section 77-A:2). A "business organization" is any enterprise organized for gain or profit, carrying on any business activity within New Hampshire, other than those expressly tax exempt under applicable New Hampshire law. For purposes of determining whether a business organization exists, foundations treated as grantor trusts under I.R.C. Section 671 are included in the returns of their owners, and the owners are subject to the tax to the extent the owners would be considered a "business organization" notwithstanding the existence of the foundation. In contrast, a foundation that is not treated as a grantor trust under federal law is subject to BPT at the entity level (N.H. Rev. Stat. Section 77-A:1, I).

Whether a foundation will be viewed as carrying on a business activity within New Hampshire requires a facts and circumstances analysis. Business activity is defined as a substantial economic presence evidenced by a purposeful direction of business toward the state examined in light of the frequency, quantity, and systematic nature of a business organization's economic contacts with the state. For these purposes, business activity "includes, but is not limited to, a group of actions performed by a business organization for the purpose of earning income or profit from such actions and includes every operation which forms a part of, or a step in, the process of earning income or profit from such group of actions. The actions ordinarily include, but are not limited to, the employment of business assets, the receipt of money, property, or other items of value and the incurring or payment of expenses" (N.H. Rev. Stat. Section 77-A:1, XII).

BET is imposed on the taxable enterprise value tax base of every business enterprise. The characterization of a foundation as a “business enterprise” is based on whether it is “engaged in or carrying on any business activity” within New Hampshire. Again, if the foundation is treated as a grantor trust under I.R.C. Section 671, the relevant determination is whether the foundation’s owners (on whose returns the foundation’s income must be reported) would be considered a business enterprise notwithstanding the existence of a foundation. The reference to “owners” in the statute appears to refer to the grantor or any beneficiary treated as an owner under I.R.C. Sections 671-679 (See N.H. Rev. Stat. Section 77-E:1, III).

“Business activity” in this context is defined differently than it is for BPT, and as with BPT, does not depend on the characterization of the activity under federal law. For BET, “business activity” means a transfer of legal or equitable title or rental of property, whether real, personal or mixed, tangible or intangible, the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in (whether in intrastate, interstate, or non-U.S. commerce) with the object of gain, benefit, income, revenue, or advantage (whether direct or indirect) to the business enterprise or to others. Business activity does not include the services rendered by an employee to an employer or services as a director of a corporation (N.H. Rev. Stat. Section 77-E:1, II).

Summary of Income Tax Treatment

Although foundations were intended to be part trust and part corporation, we anticipate that as a general rule foundations will be treated as trusts for income tax purposes. In amending state tax laws, the New Hampshire legislature conferred on foundations the same favorable tax treatment it grants to trusts, so New Hampshire foundations will generally avoid tax at the state level. For federal tax purposes, it is likely that a foundation will also be classified and taxed as a trust, rather than as a corporation.

CONCLUSION

We conclude with a few examples of situations in which New Hampshire foundations are likely to be useful. As discussed above, we expect them to be an important tool for residents of civil law jurisdictions. For example, take the case of a wealthy surgeon in Louisiana who would like to leave his assets to his wife, for her lifetime, but also wants to benefit their children. Ideally, he wants to allow the assets to benefit as many future generations as possible. Because of the risk associated with his career, he has concerns about creditors reaching these assets. He would also like to keep his children involved in managing these assets.

Louisiana does not provide for the use of domestic asset protection trusts that might otherwise be used in this situation. However, he could protect assets from creditors by contributing them to a New Hampshire foundation because the foundation is a separate legal entity. This would not require that the Louisiana surgeon appoint any New Hampshire residents as directors. Instead, his children and wife could be the foundation directors. The foundation would need a New Hampshire resident agent, but the resident agent does not have to be a director. The powers of the surgeon as the founder could be limited to prevent his creditors from being able to attach any assets of the foundation, much like an irrevocable trust, but without the requirement of using a New Hampshire trustee.

A New Hampshire foundation may also be useful for citizens of civil law countries. These clients may view the U.S. favorably due to its stable economy and robust laws, and thus wish to establish a wealth management vehicle to on-shore assets in the U.S.. The use of a foundation in this instance is ideal because foundations are easier than trusts to administer vis-a-vis civil law countries. Because there are no minimum contributions required by the act, if the surgeon described above were resident in a civil law country, he could contribute his assets for management by the New Hampshire foundation that he had created, and could continue to contribute funds over time. He would not need to use New Hampshire resident directors to manage the foundation if he prefers to be a director and manage it himself or have someone else manage it in the country in which he is resident. If he decides to act as a director, he would retain the ability to amend the foundation's governing documents. He would also be able to transfer his assets after his death to the foundation and amend the terms of the foundation over time as circumstances change.

In light of the foregoing, it is clear that New Hampshire's foundation law presents a unique opportunity for many clients. A New Hampshire foundation offers flexibility, potential tax savings, and asset protection to individuals and families across the world. We expect this new legal entity to grow in popularity as wealth management advisors gain familiarity with it.

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