

Third-Party Trusts: Tax Benefits and Asset Protection

by Edward D. Brown, J.D., LL.M., CPA, and Eric R. Kaplan, J.D.

Executive Summary

- Third-party trusts serve as an effective tool for experienced estate planners and their clients. Third-party trusts are a useful alternative for clients who feel that neither the value of their assets nor their potential creditor exposure warrant creating a more comprehensive asset protection plan such as an offshore or domestic asset protection trust.
- A typical third-party trust involves one family member settling (creating) a trust for the benefit of another family member (primary beneficiary). The third-party trust's settlor then advances a significant portion of the primary beneficiary's inheritance by transferring assets to the third-party trust.
- A third-party trust will have two trustees that manage the assets—an *independent trustee* and a *family trustee*.
- The independent trustee holds the powers that relate to the asset protection nature of the third-party trust, such as the ability to make loans or distributions to the primary beneficiary.
- The primary beneficiary typically serves as the family trustee. This role allows the family trustee to retain certain control over the third-party trust's assets as well as control over the independent trustee, without providing the family trustee with any powers that could jeopardize the third-party trust's asset protection.
- A third-party trust can be designed to be either a domestic trust or a foreign trust. Foreign trusts afford stronger asset protection features. Even if a third-party trust is foreign for asset protection law purposes, it can still be designed as a domestic trust for income tax purposes.
- A client and his or her spouse should avoid creating "reciprocal" third-party trusts, or the trusts may be exposed to creditors.

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Estate planning clients are often interested in strategies to protect their assets from future, unforeseen creditors. In restructuring the ownership of their assets to meet this objective, however, clients would prefer not to incur any gift or income taxes, or to lose control over their assets (such as the ability to repatriate the assets to the client or the ability to live off the income from those assets). This article describes an asset protection vehicle known as a third-party trust, which has the ability to accomplish these goals. The third-party trust can also fulfill the additional goal of having the client transfer assets (via a sale) to the third-party trust that can effectively freeze, or even reduce, the client's taxable estate with respect to the transferred assets.

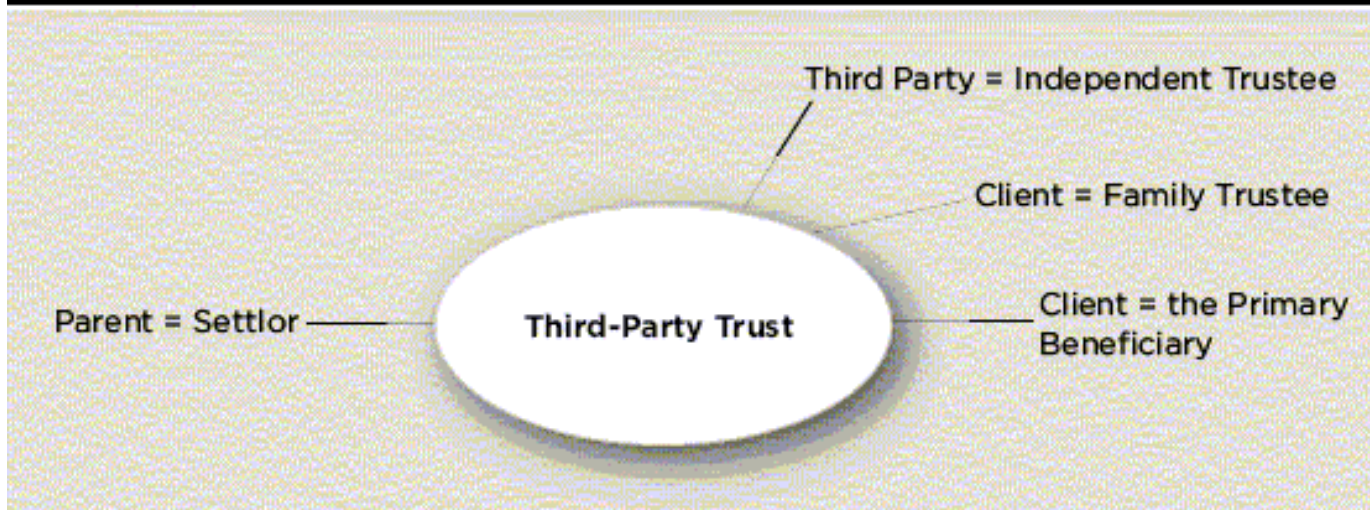
A third-party trust typically involves a parent settling (creating) a trust for his or her child (client), designated in the trust agreement as the *primary beneficiary*. The parent then advances a significant portion of that child's inheritance by transferring assets to the third-party trust. The trust usually has two trustees who hold, administer, and manage the trust's assets, and who also hold the power to distribute trust assets to the trust's beneficiaries.

The two trustees are an *independent trustee* and a *family trustee*. The reason for the two trustees is so that one trustee (the independent trustee) can hold the powers that relate to the asset protection nature of the third-party trust, such as the ability to make loans or withhold or make distributions to the primary beneficiary. The primary beneficiary is typically the family trustee. It is therefore easy to see why the family trustee should not hold such

distribution powers. For example, if the family trustee held the power to distribute assets to himself as a primary beneficiary, then his creditors might be able to obtain a court order forcing the family trustee to make distributions to himself in order to pay off the debt owed to the creditor.

Clients usually prefer to serve as the family trustee, as this role allows the client to hold certain controls over the trust's assets and over the independent trustee, yet not provide the family trustee with any powers that could jeopardize the trust's asset protection. One aspect of "control" that the client likes to have as the family trustee is the authority to replace an independent trustee if the independent trustee is not fulfilling his or her fiduciary duties. The family trustee (who is, again, usually the child/primary beneficiary) also holds the power to manage, sell, or reinvest the trust's assets. We refer to this trust structure as a Type I third-party trust (see Figure 1).

Figure 1: Type I Third-Party Trust



Instead of the parent contributing all or a large portion of the child's inheritance to the Type I third-party trust, the parent may decide to contribute only a small amount of the child's inheritance to the trust. This serves as seed money for the family trustee to reinvest in a (hopefully) successful business venture.

The third-party trust can be designed in one of these different ways. One design involves the use of a domestic asset protection trust (DAPT). A DAPT is a trust created under the laws of one of the nine states that has enacted specific asset-protection legislation for self-settled trusts. Another design involves creating the trust under the laws of one of the 41 non-DAPT states. The final design involves the use of a foreign trust, which provides protection from creditors pursuant to the laws of the applicable foreign jurisdiction. The foreign trust affords stronger asset protection features. Notwithstanding that the trust is foreign for asset-protection-law purposes, such a trust can still be designed as a domestic trust for income tax purposes.

The Goal of Asset Protection

With a few exceptions, an individual's assets are subject to creditor claims. The exceptions, however, have varying limitations. For example, nine states¹ have enacted laws allowing the formation of self-settled asset protection trusts² that are funded by the client with assets that thereby become protected from that client's future potential creditors. Such a domestic asset protection trust may be defined as a self-settled spendthrift trust, but in most other states, self-settled trusts are not protected from the settlor's³ creditors.

As an example of the use of trusts in the DAPT states, consider Dr. Bob, who has been sued ten times and divorced three times. With each of these unpleasant experiences his net worth has been halved. Dr. Bob could be the poster boy for advanced asset protection planning. Here are some options he should consider. He might

gift to his newest wife, but this is not such a great option if she ends up becoming the next ex-spouse creditor. Alternatively, he could form a trust in Nevada for himself and his children. Nevada law allows such a self-settled trust to be protected from Dr. Bob's future creditors.⁴ If, however, Dr. Bob knows no one in Nevada to serve as the trustee, or is not comfortable using a Nevada trustee company,⁵ he may decide to educate his parents about forming a trust in a non-DAPT state. The trust should be a third-party trust created for Dr. Bob's benefit.

A third-party trust is not a self-settled trust. It is a trust created by a person (referred to throughout this article as the settlor) who is a family member of the trust's primary beneficiary. In Dr. Bob's example, his mother could be the settlor. Therefore, Mrs. Bob creates the third-party trust for the benefit of her son. She then places \$100,000 in the third-party trust (as an advancement of Dr. Bob's inheritance). As a result of the trust not being self-settled, Mrs. Bob's creditors cannot access that \$100,000. Also, because Dr. Bob does not own the third-party trust's assets, his creditors also cannot access the third-party trust's assets. Dr. Bob has protection not only for the inheritance advancement, but also has protection for his own appreciating assets by selling them to the third-party trust in exchange for a depreciating asset (an installment note that decreases in value as principal repayments are made to Dr. Bob). This way, all the future appreciation on Dr. Bob's own personal assets is removed from creditor reach.

The Goal of Gift Tax Avoidance

Completed transfers to a trust are generally subject to the federal gift tax if the transferor does not receive, at a minimum, something of equal value in return for the transfer. This would apply to the settlor's (for example, the parent's) contributions to the third-party trust. Note that the client/beneficiary should not make gratuitous contributions to the third-party trust. Instead, the client/beneficiary can transfer assets to the third-party trust only in exchange for something of equal value, such as an installment note or private annuity of equal value. No gift taxes, therefore, result. Not only does this avoid gift taxes, it also avoids causing the trust to become a self-settled trust.

The Goal of Income Tax Avoidance

The third-party trust can be designed so that the client/beneficiary can transfer assets to the third-party trust without incurring any income (such as capital gain) taxes. As noted above, the transfer of assets to a third-party trust can be achieved by the client selling the assets to the third-party trust in exchange for an installment note. To avoid potential income taxes on such a sale, the trust needs to be designed as a grantor trust⁶ with respect to the client. This is done by giving the client/beneficiary certain powers as described in Internal Revenue Code (IRC) Section 678. As long as the third-party trust is structured as a grantor trust under Section 678 with respect to the client, the sale of assets to the trust results in no taxable gain to the client.⁷ In effect, the Internal Revenue Service treats such a sale as a sale by the client/beneficiary to himself.⁸ But in some states (other than DAPT states and certain foreign jurisdictions), it is preferable not to make the third-party trust a grantor trust as this could result in a lower level of asset protection for the client (a discussion of which is beyond the scope of this article). Therefore, if tax-free sales to a trust are an important component of a client's estate plan, he or she may prefer to create a separate intentionally defective irrevocable trust⁹ designed to remove assets from his or her taxable estate.

If a client's spouse settles a third-party trust, Section 678 cannot be used to cause the third-party trust to be a grantor trust for the client because the client's spouse is deemed under the IRC to hold all the powers under Sections 671 through 677 that are granted to the client. The application of Sections 671 through 677, regarding powers retained by the settlor (that is, the client's spouse), can override the application of Section 678. As a result, the client's spouse (as opposed to the client) is treated as the trust's grantor (that is, the person to whom all trust income is taxable) for grantor trust purposes, which prevents the sale by the client to the third-party trust from being treated as a sale to himself.¹⁰

As mentioned before, the third-party trust can be classified as a foreign trust for asset-protection-law purposes and yet be treated as a domestic trust for income tax reporting purposes. If for any reason the third-party trust is treated as a foreign trust for income tax purposes,¹¹ the Section 678(a)(2) treatment of the trust (which allows for the tax-free sales of assets by the client to the third-party trust) will be supplanted by Section 679. This may supersede the ability of the client to sell assets tax-free to the third-party trust.¹²

Instead of the client's sale of assets to the third-party trust being in exchange for a garden-variety installment note, the sale can be accomplished as a sale in exchange for (as mentioned earlier) a private annuity. If structured properly, the client's estate will reflect a zero value for the private annuity that he holds at his death, thereby serving as a useful estate-tax reduction strategy.¹³

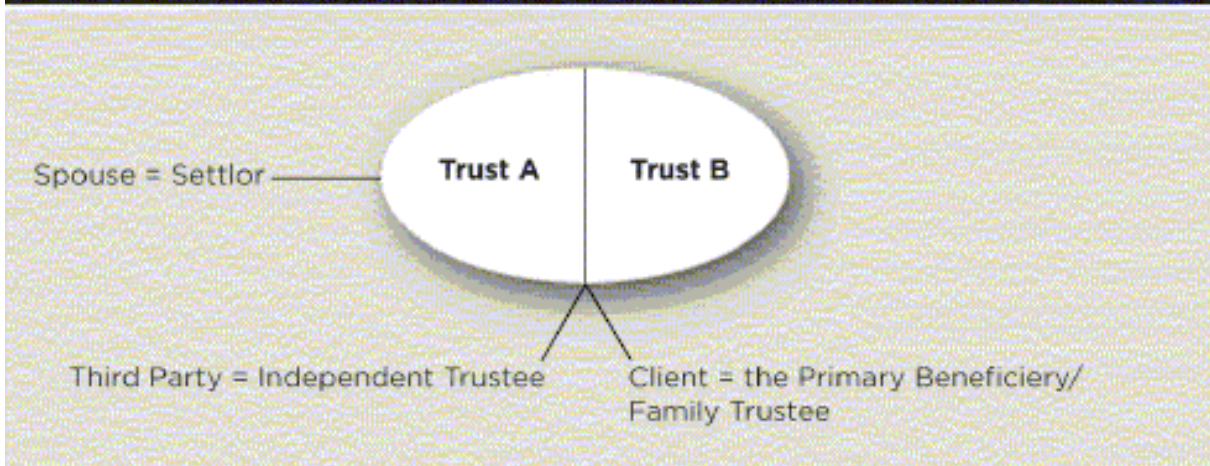
It is important that the private annuity or installment note's initial value be at least equal in value to the value of the assets sold to the third-party trust. Otherwise, the transfer to the third-party trust would be treated as a part sale-part gift transaction (and therefore the trust would be considered partially self-settled). For example, to avoid having an installment note valued at less than the assets sold to the trust, the installment note must have a face value equal to the sold assets' fair market value and the installment note's effective interest rate must be at least equal to the applicable federal rate described in Section 7872.¹⁴

Avoidance of the Need to Enter into an Installment Sale

If a spouse is involved, the third-party trust may be implemented without the need for an installment sale. The trust can instead be funded entirely by spousal contributions, with client-originated funds, as described later. The client may want to avoid the need for an installment sale for a number of reasons. For example, the client may prefer not to sell assets to the trust for fear that the resulting installment note owned by the client will be subject to his creditors, or he may prefer to not have the installment note subject to estate taxes upon his death. Should this be the case, the client should initially consider gifting assets outright to his spouse for independent reasons, such as estate planning involving the equalization of the spouses' estates or for the purpose of placing the larger estate in the hands of the spouse with the longer life expectancy so that she can learn to manage those assets in preparation for the client's probable earlier death.

The recipient spouse can later settle an inter vivos A/B trust¹⁵ for the client's benefit. This way, the spouse who settles the A/B trust for the client's benefit can design it to have standard third-party trust features. As discussed further in this article, such features could include allowing the client to be the "family trustee" in order to conduct daily trust asset management activities, and allowing an independent co-trustee to have certain tax or creditor-sensitive powers, such as the power to appoint trust assets to the client. The authors refer to this type of spousal trust as a Type II third-party trust (see Figure 2).

Figure 2: Type II Third-Party Trust



If the client prefers not to gift assets to the spouse or have the spouse settle a Type II third-party trust for the client to achieve the desired result, the client himself can simply settle the A/B trust for his spouse’s benefit (discussed below and referred to as a Type III third-party trust). A Type III third-party trust is similar to the Type II trust except that it is created by the client as opposed to being created by the client’s spouse (see Figure 3 and Table 1 on the next page, which reflects all three types of third-party trusts).

Figure 3: Type III Third-Party Trust

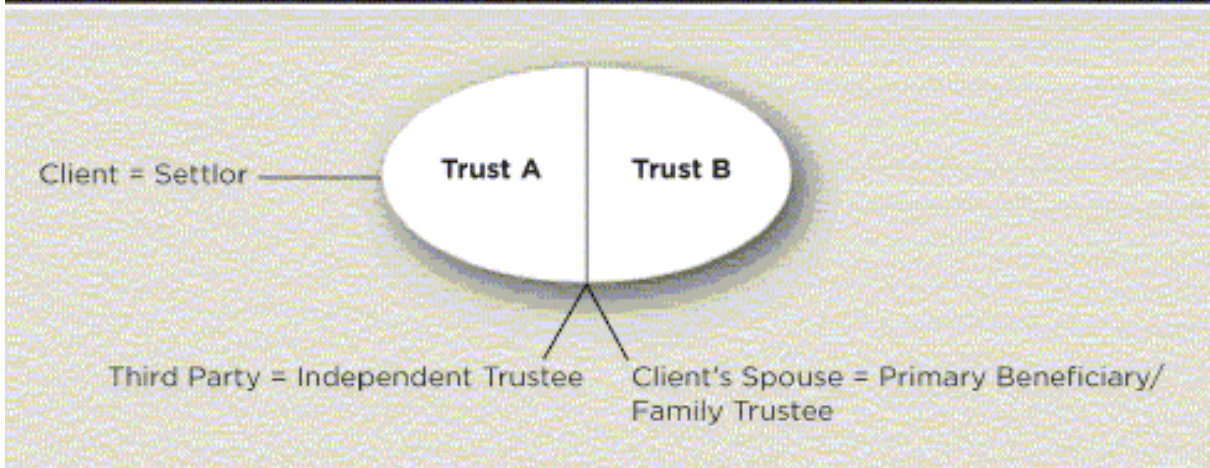


Table 1: Three Types of Third-Party Trusts

	Settlor	Primary Beneficiary	Creditor Protected for...	Assets Are Excluded from Estate of...
Type I Third-Party Trust	Parent	Client	Both	Both
Type II Third-Party Trust	Spouse	Client	Both	Spouse (and client to some extent)
Type III Third-Party Trust	Client	Spouse	Both	Client (and spouse to some extent)

Regardless of whether a Type II or Type III third-party trust is implemented, such a trust would be funded as follows: Trust A and Trust B would be funded with the \$1 million amount that can be gifted over one’s lifetime without incurring a gift tax (the gift exemption amount), with the remainder of the transfers being funded into Trust

A,¹⁶ for which a QTIP election is made. The QTIP election allows Trust A to qualify for the unlimited marital deduction for gift tax purposes. The settlor's¹⁷ spouse can be the family trustee of Trust A and Trust B, with the special power to appoint Trust B's assets to the settlor or other family members (other than the powerholder). The independent trustee (who could even be the settlor) would be required to pay all of Trust A's income to the settlor's spouse at least annually. Upon the death of the settlor's spouse, the independent trustee (which at that point may need to be someone other than the settlor's) would direct that all income of a new Trust A be paid to the settlor for the rest of the settlor's life (which allows the deceased spouse's estate to benefit by the marital deduction). This way, the settlor continues to benefit from the income of Trust A's assets. Upon the settlor's death, the settlor may hold a testamentary power to appoint the assets among a class of family members.¹⁸

The \$1 million in assets transferred to Trust B may also benefit the settlor in that those assets can find their way back to the settlor, if need be, pursuant to the power of appointment held by the settlor's spouse or children. This \$1 million gift exemption amount can also be leveraged if the settlor first places assets into a limited liability company (LLC) designed to maximize the discounting (discussed later) of the value of the LLC interests, followed by the initial funding of Trust B with the LLC interests.

If the settlor's spouse or other powerholder fails to exercise the power of appointment over Trust B, then the trust can direct that, upon the spouse's death, the assets will be retained in trust for the benefit of the settlor's children, who in turn can be granted the power to appoint the assets among a group of permissible appointees that include the settlor.

Two items worth noting: (1) upon formation, both Trust A and Trust B are effectively removed from the settlor's estate without incurring any gift tax and (2) Trust A and Trust B may not necessarily, and should not in certain cases, be designed as grantor trusts with respect to the settlor.

Maintaining Control over the Third-Party Trust's Assets

If a third party (such as the client's spouse in a Type II third-party trust) is the settlor of a third-party trust, a method used to allow the trust assets to continue to be controlled by the client is to designate the client as one of the two trustees. One trustee is an independent individual who possesses the power to provide benefits to the client. This is important in order to avoid providing the client with tax-sensitive powers that could cause the third-party trust's assets to be taxable in the client's estate.¹⁹ By "tax-sensitive powers," the authors are generally referring to the power to distribute or loan assets to the client. Isolation of such power to only the independent trustee is necessary to avoid allowing a client's creditor any access to the third-party trust's assets. For example, if the client served as the independent trustee, and held the power to distribute assets to himself, the client's creditor could conceivably latch onto this power by forcing the client, through a court order, to make distributions to himself to allow him to pay the creditor's claims. The independent trustee should therefore exclusively hold such power over the third-party trust's assets.

The client may possess all other powers over the third-party trust's assets, including the day-to-day management of trust assets and the sale and reinvestment of those assets. These powers would be exercisable in the capacity of a *family trustee*, as opposed to the independent trustee. The client, as family trustee, also can be empowered to replace the independent trustee with another independent trustee if the client determines that the existing independent trustee is not fulfilling his or her fiduciary duties pursuant to the trust instrument's terms. If the client wants to further distance himself for better asset protection, the third-party trust could be designed to give someone other than the client the power to remove a trustee. Such power could be held by yet another independent party (referred to sometimes as a *trust protector*). If the third-party trust is designed as a foreign trust, this power also may include the ability to remove or replace the foreign trustee.

To recap, to avoid having the third-party trust's assets subject to the client's future potential creditors, the third-party trust *cannot* be created or directly funded by the client. If the client creates a trust for his own benefit, then it

is a self-settled trust, which means the client's creditors are more likely to be able to access the third-party trust's assets, unless the trust is set up in a DAPT state. Instead, a relative such as a parent or spouse should create the third-party trust and capitalize the trust with an initial contribution.

As one example of how this could be done, if the client had previously gifted all or a large portion of his assets (at a time that the client had no expected, anticipated or pending creditor claims) to his spouse in an unrelated transaction during a previous year, the recipient spouse could now form and fund a Type II third-party trust for the benefit of the client and his children. The third-party trust can be designed to allow the client (primary beneficiary) to possess a power to appoint third-party trust assets to third parties, such as the client's spouse (the settlor).²⁰ The spouse can in turn use those funds, or even later gift those funds back to the client. The converse of this involves the client forming and funding a Type III third-party trust for his spouse's benefit (at a time that the client had no expected, anticipated, or pending creditor claims), with the client's spouse being designated as the family trustee as discussed earlier.

Avoid Reciprocal Trusts

The client and his spouse would, however, want to avoid creating third-party trusts for each other. If two such reciprocal trusts were created, especially where the provisions of each are mirror images, the trusts may be viewed by a court as being self-settled trusts (that is, deemed as though the client formed a third-party trust for himself, and his wife formed a third-party trust for herself). This could result in two potentially creditor-exposed trusts set up for the settlors' own respective benefit. This is known as the Reciprocal Trust Doctrine and is a trap for the unwary.

Applying estate tax concepts to this situation, however, the reciprocal *deemed self-settled* trusts could be avoided if the two third-party trusts have a number of different provisions from one another, are formed at two different times, and are not interdependent. This increases the likelihood that each third-party trust would stand on its own instead of being treated as a trust that was effectively created by the non-settlor spouse. An example of using different provisions in each trust to avoid the "mirror-image" problem may be illustrated by having the husband-created third-party trust be for his wife's benefit and her siblings' benefit, with each beneficiary holding a testamentary special power to appoint certain assets in the trust to certain persons other than the respective powerholders. In contrast, the wife-created third-party trust could be for the benefit of her husband and their children, and it could allow the husband to withdraw up to \$5,000 a year (on top of any distributions he might otherwise receive). Also, if the husband creates the third-party trust in 2008 but the wife does not create a third-party trust until 2011, this may be a factor that leads to the conclusion that the trusts were the result of independent motivating factors; therefore, each should be individually respected and stand on its own merits.

Creating a third-party trust for one's spouse is a superior planning alternative to simply having one spouse (that is, the client who is concerned with being a target for lawsuits although none are currently anticipated, expected, or pending) make outright gifts of assets to the other spouse. For example, the simple gifting approach allows the recipient spouse to do as he or she wishes with those assets. Also, in a divorce situation, assets previously gifted from one spouse to another will likely constitute the separate property of the recipient spouse, not subject to division by a divorce court.

Contributing to a third-party trust still can result in gifts of assets to a recipient spouse. The recipient, however, is not totally free to dispose of those assets as he or she may want. The recipient may be granted the power to appoint those assets only to the donor spouse or the children of their marriage. This way, the recipient spouse cannot appoint the assets to parties outside the client's immediate family. The recipient, alternatively, may be given the power to appoint to others as long as the recipient spouse is married to and living with the client. This way, the client retains control over the recipient spouse's ability to squander assets, and yet the control involves an action that has its own independent significance. This is important under the gift tax rules to ensure that the contributions to the third-party trust are considered "completed" gifts for the recipient spouse's benefit.²¹

Reducing the Client's Taxable Estate

The third-party trust can be designed to hold assets outside of the client's taxable estate. As mentioned earlier, this is possible, in part, because an independent trustee is given the tax-sensitive powers that, if held by the client, would cause the third-party trust assets to be included in the client's taxable estate.

If the client uses the installment sale technique described earlier, there would be no immediate reduction in the value of the client's estate after such sale because the client would still hold an installment obligation equal in value to the assets sold to the third-party trust. This does not mean, however, that there are no estate tax benefits to be obtained. For example, if the assets sold to the third-party trust appreciate in value (in contrast to the installment note held by the client), all such appreciation would escape estate taxation (that is, an effective "estate freeze" tool).²²

If, instead, a private annuity is held by the client in lieu of the typical installment note, the transaction serves as an estate reduction strategy in lieu of just an estate freeze.²³

Another example involves the client who first places his assets in an LLC, followed by a sale of a 99 percent interest in that LLC to the third-party trust at a discounted price. A discount can be achieved due to minority or marketability discounts to reflect the trust's lack of control over the LLC assets or the lack of a market to which the trust can sell the LLC interest. As a result, the installment note received by the client in exchange for the sale of the LLC interest to the third-party trust is for a face amount that is substantially lower than the value of the LLC's underlying assets. This serves as an effective immediate reduction in the value of the client's taxable estate. The key here is to obtain a professional, independent valuation to substantiate the discount claimed.

This strategy, however, may encounter issues raised by Section 2036 and recent case law. Specifically, the IRS has, in certain circumstances, been successful in treating the full value of an LLC's underlying assets as includible in a taxpayer's taxable estate if the client continues to control the LLC as either a member or manager. Section 2036 should be avoidable here because a "sale" is an exception to the application of Section 2036. However, in an abundance of caution, it may be advisable to suggest to the client in the example to transfer the remaining 1 percent interest in the LLC to an independent third party²⁴ in whom the client has a great deal of confidence, and allow that third party to become the LLC's manager.

Other strategies have been suggested to avoid this issue. One is establishing a significant non-tax purpose for the LLC, such as forming the LLC in a state such as Arizona, Wyoming, Delaware, or Nevada, each of which has strong asset protection law for LLCs by providing charging order protection as the exclusive remedy to creditors (a discussion of which is beyond the scope of this article). This can be coupled with other strong evidence that the client's formation of the LLC is heavily motivated by asset protection reasons as opposed to estate exclusion reasons. Case law supports the view that if the LLC is created for non-tax purposes, Section 2036 may be entirely avoided. This is due to the formation and funding of the LLC being treated as involving transfers for adequate consideration versus gifts of assets. Section 2036 may also be avoided if the LLC holds significant business assets as opposed to passive investment-type assets. This is because a business purpose as opposed to a tax-avoidance purpose is the dominant motivation for creating the LLC.

In situations that do not have a sufficient non-tax purpose needed to avoid Section 2036, the client may still avoid having the LLC's assets included in his or her estate by having the LLC's terms preclude distributions to the client. This way, Section 2036(a)(1) may be avoided because the donor retains no benefit to the LLC assets. Section 2036(a)(2), however, can still present a problem. This code section is a threat as long as the client retains the ability, even if exercisable only in conjunction with others, to affect the beneficial enjoyment (such as distributions) of the LLC assets.

Conclusion

The third-party trust serves as an effective tool to accomplish a variety of goals. It is a useful alternative for clients who feel that neither the value of their assets nor their potential creditor exposure warrants creating a more comprehensive asset protection plan, such as a trust created in a foreign jurisdiction. Although a third-party trust can offer asset protection through the use of a foreign trust, a third-party trust may still serve the asset protection goals without the need to go offshore or the need to use one of the DAPT (domestic asset protection trust legislation) states that have previously enacted asset-protection laws for self-settled trusts.

Endnotes

1. Alaska, Delaware, Missouri, Nevada, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming have enacted domestic asset protection trust legislation.
2. Meaning a trust created by the primary beneficiary of that trust.
3. The term “settlor” shall refer to the person who creates the trust.
4. See Nev. Rev. Stat. Section 166.010 *et seq.* (2007).
5. Pursuant to Nev. Rev. Stat. Section 166.015(2)(a)-(c), if a settlor is a beneficiary of a trust, at least one trustee of a spendthrift trust must be (a) a natural person who resides in and is domiciled in Nevada; (b) a trust company that (1) is organized under federal law, Nevada law, or the laws of another state, and (2) maintains an office in Nevada for the transaction of business; or (c) a bank that (1) is organized under federal law, Nevada law, or another state’s law, (2) maintains an office in Nevada for the transaction of business, and (3) possesses and exercises trust powers.
6. By referring to a “grantor trust,” the authors are referring to a trust in which the contributor of assets (by gift) to the trust retains certain rights or powers over the trust, resulting in the trust’s income or capital gains being taxable directly to such contributor under Sections 671 through 678 of the Internal Revenue Code of 1986, as amended.
7. See Section 678 and how it interacts with Sections 671 through 677 of the Internal Revenue Code.
8. For sake of simplicity, all pronoun references to the client shall be in the male gender, while all pronoun references to the client’s spouse shall be to the female gender.
9. An intentionally defective irrevocable trust is a grantor trust that contains assets, none of which are includible in the contributor’s taxable estate.
10. Even so, if a trust is created by the spouse of the client for that spouse’s own benefit, the client can still sell assets to such trust income-tax-free pursuant to Section 1041. If the client chooses this strategy, he should first be comfortable that his spouse will not be a target for any lawsuit since she will be the primary beneficiary of a self-settled trust created by her, and hence, not a third-party trust.
11. For example, if any substantial trust decisions are not made by U.S. persons or if a U.S. court does not have primary supervision over the administration of the trust, it will be treated as a foreign trust; see Section 7701(a)(30).
12. Such a sale would, however, be income-tax free if the trust is designed for the benefit of the client’s spouse, and that spouse is the settlor of the trust (Section 1041). Of course, the trust then would not be a third-party trust.
13. See *Costanza*, 320 F.3d 595, 91 AFTR2d 2003-988 (CA-6, 2003), rev’g TCM 2001-128. Of course, to the extent the annuity payments received by the client are not spent on living expenses, such payments will be included in the client’s taxable estate.
14. See *E. Krabbenhoft*, 94 TC 887, Dec 46,659, *aff’d* CA-8, 91-2 USTC par. 60,080 (1991); *E. Frazee*, 98 TC No. 37, Dec. 43,192 (1992). Of course, a private annuity requires a slightly different analysis since it does not involve interest payments, *per se*.
15. The authors use the term “A/B trust” to refer to a trust that qualifies for the estate tax exclusion amount (which is \$2 million in 2007) (the B trust), with the rest of the trust qualifying for the unlimited marital estate tax deduction (the A trust).
16. A qualified terminable interest property (QTIP) trust meets Section 2056 requirements to make it eligible

for the gift tax marital deduction.

17. In a Type II trust, the settlor is the spouse. In a Type III trust, the settlor is the client.
18. For a similar fact pattern, the reader should review Private Letter Ruling 200406004.
19. For example, if the client has the discretion to distribute assets to himself, this could constitute a general power of appointment under Section 2041, which would cause the third-party trust to be included in the client's taxable estate.
20. Certain tax issues need to be analyzed when creating these powers. For example, if the client has an inter vivos special power to appoint all or a portion of the third-party trust assets to his spouse or anyone other than himself, that portion would not qualify for a marital deduction. Also, the trust could be designed to be an incomplete gift by the settlor (for example, having the settlor retain a special power of appointment over the trust assets) so that no gift tax occurs. This, however, will also not remove the trust assets from the settlor's taxable estate.
21. For an example of the effect events of independent significance have, see Ltr Rul 9514017 and *Kurz*, 101 T.C. 44 (1993).
22. An estate freeze is a technique whereby the client takes measures to remove the future appreciation of assets he or she owns from their taxable estate.
23. See note 11.
24. This third party could be a separate irrevocable trust with an independent trustee who holds the 1 percent member interest and manager position for the benefit of the separate trust's beneficiaries (such as the client's children).

Web Sites for Further Research

- www.engelreiman.com
- www.oshins.com