Asset Protection Trusts in Tennessee

The Tennessee Investment Services Act of 2007, effective July 1, 2007, allows for the creation of a trust that benefits the Grantor and family and that provides protection from creditors. As of July 1, 2013, that protection is even stronger thanks to recent amendments to the Tennessee Trust Code.

History of Asset Protection Trusts

The general rule in the U.S. is that where a person creates a trust for his own benefit, provisions which protect the trust assets from a voluntarily or involuntary transfer to creditors is void absent statutory provisions to the contrary. In the past, it has generally been impossible to create a trust for yourself and protect the assets from your creditors.

Protection of trust assets for creditors for the benefit of a beneficiary other than the Grantor can be easily accomplished. John can create a trust for Linda giving the Trustee the authority to distribute income or principal for the health, support and care of Linda but, at the same time, protect the assets from Linda’s creditors or those who would seek to take the assets away from Linda. In the past, the rules have not allowed John to create the trust for his own benefit and protect the assets from his creditors.

Offshore Trusts

In an effort to find a haven where one can place assets and shelter them from creditors, some have turned to offshore trusts. For most, they are not an attractive option. First, such trusts have a bad reputation. Some have used offshore trusts to improperly avoid income tax on trust earnings. The IRS has vigorously pursued those individuals. Transferring funds to foreign countries, structuring a trust document under foreign country tax laws and placing one’s assets outside of the U.S. produces an uncomfortable feeling for most. There is financial risk of political change in a foreign country. There is a valid concern that if the creditors cannot get the assets, will you be able to reach them.

Asset Protection Trusts in the United States are new. In 1997, Alaska was the first state to pass an asset protection statute which allowed a Grantor to transfer assets to a trust company located in Alaska and protect the assets from the Grantor’s creditors. Delaware and Nevada followed with similar asset protection statutes. Rhode Island, Utah, Missouri, and Wyoming subsequently passed statutes providing for lesser degrees of asset protection for Grantors.

Tennessee Asset Protection Trusts

In order to establish an Asset Protection Trust under the laws of Tennessee, a number of criteria must be met. First, the trust must be irrevocable. This means such a trust cannot be lightly con-
Decisions need to be made as to the beneficiaries of the trust, the trust provisions, when the trust ends, and how the trust assets are to be managed.

The trust must have its situs or residence in Tennessee and the Trustee must either be a Tennessee resident, or a bank or trust company licensed to do business in Tennessee. The majority of the assets must be located and housed in Tennessee. It is recommended that all assets be located and managed in Tennessee. One statutory requirement that is often overlooked is that the trust must have at least some of its assets physically located in Tennessee, such as a bank account or real estate.

The trust must meet stringent requirements regarding the structure of the trust. Specific language must be included in the trust to provide that the interest of the Grantor and other beneficiaries may not be transferred, assigned, pledged or mortgaged. Thus, once the assets are placed in the trust, they cannot be used to secure any debt of the Grantor.

Upon establishing the trust, the Grantor must show that he has a full right, title and authority to transfer the assets into the trust, that the transfer will not render the Grantor insolvent, that the transfer is not intended to defraud creditors and that the Grantor does not have any pending or threatened court actions against the Grantor except those as may be fully disclosed in the process of establishing the trust.

Likewise, the Grantor must show that he is not involved in any administrative proceedings such as an EPA investigation, except as may be fully disclosed, that the Grantor does not contemplate filing bankruptcy and that the assets are not derived from any unlawful activities.

**Income Tax Issues**

Because the income of the trust “may” be paid to or for the benefit of the Grantor, the trust is deemed to be a Grantor Trust for income tax law. What this means is that all income of the trust is taxed to the Grantor. Even if the income is paid to a spouse, a child, or other beneficiary, the Grantor pays income tax on the income. If the income is retained in the trust, the Grantor pays tax on that income as well.

**Gift Tax Issues**

Because the trust is an irrevocable trust, there are immediate gift tax concerns that must be addressed at the formation of the trust. The trust can be structured so that gifts to it either are completed gifts for gift tax purposes or incomplete, depending on the Grantor’s goal. In some circumstances, the trust may be able to be excluded from the Grantor’s estate if it transfers to the trust are completed gifts.
Estate Tax Issues

Because the trust income or principal “may” be paid to or for the benefit of the Grantor, the trust is generally included in the estate of the Grantor for estate tax purposes. In addition, other powers which the Grantor will likely retain and which are discussed below result in the trust assets being taxed in the estate of the Grantor at the Grantor's later death. If the Grantor is willing to retain less control, it may be possible to prevent the trust from being included in the Grantor’s estate for estate and inheritance tax purposes, even though the Grantor is a beneficiary. Usually, IRC Sec. 2036 will cause such a trust to be included in the Grantor's estate, however, if the trust is not available to Grantor’s creditors, and there is no ascertainable standard of distribution that the Grantor can enforce, then there is a strong argument the trust will escape inclusion. Due to exceptions the Tennessee statute, this only works if 1) the Grantor has a prenuptial agreement if married, 2) has sufficient assets outside the trust to satisfy the prenup, and 3) if there are no minor children to whom he could be required to pay child support from the trust.

Distribution Provisions for the Grantor

Common law generally provides for three types of trusts. The first type of trust is a mandatory trust. An example of this would be a trust that requires all income to be paid to the beneficiary. The second type of trust is a support trust, that is, a trust which requires the income or principal to be distributed for the health, education, maintenance or support of a beneficiary as needed. The third type of trust is a discretionary trust. A discretionary trust is one which gives the Trustee very broad discretion as to whether or not to pay income or principal to a beneficiary and when to pay it.

The benefits provided by an Asset Protection Trust are more limited in mandatory trusts and far greater as the trust moves from a mandatory to a support the trust and then to a discretionary trust. If the trust requires the payment of income to the Grantor, then once the income is received by the Grantor, the creditor can attach it. Accordingly, using a discretionary trust and giving the Trustee broad discretion as to whether or not not to pay income or principal should be paid to the Grantor or used for the benefit of the Grantor adds to the protection otherwise available.

Fraudulent Conveyances

The big question that will be asked with most Asset Protection Trusts is whether or not, when the Grantor established the trust, he was doing so with the intent of defrauding existing or future creditors. The statute gives creditors who exist before the transfer to the trust the greater of two years (previously four) from the date the transfer was made or the obligation was incurred; or six months (previously 1 year) from the date the transfer or obligation was discovered or could have been reasonably discovered to come forward and assert that the establishment of the trust was to defraud creditors. Creditors whose claims arise after the creation of the trust have two years from the date of the transfer to the trust to assert that the transfer was fraudulent.
The 2013 amendments to the TN Uniform Trust code made three significant changes to the fraudulent conveyances law applicable to spendthrift trusts:

1. Shortened the time period to bring a claim from 4 years to two years from the date of a transfer to a spendthrift trust. It also reduced the 1 year time period from when a creditor knew or should have known about the transfer to six (6) months.

2. Made it more difficult to prove a fraudulent transfer case by raising the proof standard to “clear and convincing,” from “preponderance of the evidence.”

3. A creditor is deemed to have discovered the transfer to a trust at the time any public record is made, such as filing a deed with a county register’s office.

None of this is important if, when the trust is established, it was not done with the intent to defraud existing or future creditors. The law provides clear guidelines which allow for the establishment of such a trust. If the guidelines are followed, the trust assets are protected. If the intent of the Grantor was to defraud creditors, the trust will be of little benefit.

**Bankruptcy Law Considerations.**

Because federal law supersedes state law, if a person is forced into bankruptcy by his creditors, there is a longer 10 year “look back” period that applies. The bankruptcy code provides that if a transfer was made to a self settled trust within 10 years of a bankruptcy proceeding, with the intent to hinder delay or defraud present or future creditors, the bankruptcy court can pierce the trust and access all trust assets for the bankruptcy creditors. In one recent Alaska case (*In re: Huber*, 201 B.R. 685 (Bankr. W.D. Wash., May 17, 2013) this happened where the grantor of the trust was solvent at the time of trust creation, but creditors of debts he incurred later forced him into bankruptcy. The judge looked at the plain language of the trust as evidence there was intent to hinder, delay or defraud creditors and brought the trust assets into the bankruptcy estate.

**The Trustee**

Perhaps the most significant question to be resolved after those associated with the formation and terms of the trust is naming a Trustee. The Grantor cannot be his own Trustee. The Grantor should not have a straw man Trustee, that is, someone who simply acts for the Grantor, allowing the Grantor to truly control and manage the trust.

Trustees must maintain or arrange for the custody in Tennessee of the assets, maintain trust records, prepare or arrange for the preparation of tax returns or the Trustee must otherwise materially participate in the management of the trust.
In an effort to retain control, there is a tendency to want to appoint some family member as the Trustee. Appointing one’s brother may sound like a good idea but if the brother does not appropriately administer the trust, and he likely will not because he does not fully understand or appreciate the rules, the trust may fail to protect anything.

Naming a spouse as a Trustee may sound like a good idea until a divorce. Naming a child may also sound like a good idea until the child realizes that for every dollar he distributes to the parent, he has lost a dollar in inheritance.

The law requires expertise in administering the trust correctly. It is likely that a court will give more weight to an Independent Trustee’s actions than a close friend or relative. A close relationship with the trustee makes the trust look like a sham run by you, your child, your brother or your best friend.

Powers You Can Keep

The Grantor can retain a number of powers. First, he can retain the power to direct the investments. This gives the Grantor control over how the trust assets are managed. He can also retain the power to veto a distribution to any other beneficiary, such as a child.

The Grantor can retain the power at death to adjust the distribution provisions of the trust and direct the assets at death to a predetermined group of persons whom you desire to receive the assets.

The Grantor can receive trust income and demand up to 5% of the trust principal each year. Otherwise, distributions of income and principal are and should be in the discretion of the Trustee. The Grantor can retain the right to remove the Trustee and appoint a Successor Trustee and remove trust financial advisors and appoint successor financial advisors.

Non-Tennessee Residents

Non-Tennessee residents can establish a Tennessee Asset Protection Trust by using a Tennessee Trustee. In doing so, they subject themselves to Tennessee law. It is still unclear how the Full Faith and Credit Clause of the U.S. Constitution would affect the trust in a situation where a non-Tennessee resident was successfully sued outside of Tennessee. Arguably, Tennessee has to give full faith and credit to judgments from other states, unless it is against the strong public policy of Tennessee. We do not whether non-Tennessee judgments from other states would be enforced against the trust or no.

Conclusion

This law is still a relatively a new law. There will be court decisions rendered with respect to questions associated with how the law works and the extent to which the law works. Much will be resolved in the next decade. The law is not designed to allow you to place all of your assets in such
a trust. It is designed to let you place a portion of your assets, presumably non-retirement related investment assets which make up a part of your overall estate.

The trust is not a vehicle which allows you to cancel your liability insurance coverage. If sued, you still need to defend the lawsuit. The trust does not protect you from lawsuits. The trust protects the assets from attachment by creditors if someone gets a judgment against you. An Asset Protection Trust should be a part of your overall financial and estate plan. Established and administered correctly, it should protect assets for that rainy day when all else may be lost.

What we know is that without an Asset Protection Trust, your assets are subject to claims of your creditors. With an Asset Protection Trust they should be protected. Properly structured, an Asset Protection Trust will be a valuable addition to your overall estate and financial plan.

C. Michael Adams, Jr.
Wyatt, Tarrant & Combs, LLP
901.537.1000
madams@wyattfirm.com