WHERE THERE’S A WILL BY EDDY R. SMITH

In Tennessee, ‘T’ Stands for Trust

Estate planning in Tennessee has changed significantly since the beginning of the millennium. Federal estate and gift tax exemptions have grown dramatically, and Tennessee has repealed its inheritance and gift taxes. At the same time, fewer clients today are confident that their wealth will multiply several times throughout their lives. These two factors combine to make transfer tax planning a more limited need for Tennessee residents, and fewer trusts are created with a transfer tax motive. Some assume trusts will no longer have a prominent role in estate plans.

Readers of this column and those who follow Tennessee trust law know better. There have been at least seven major trust statutory initiatives since 2000, and they work together to make Tennessee an attractive jurisdiction for establishing and maintaining trusts.¹ This column has addressed the changes over the years, but now is a good time to review the reasons why even those with modest wealth can benefit from including trusts in their estate plans.

Trust Opportunities in Tennessee

Long-Term Trusts. In 2013 Tennessee’s trust law was modified significantly, with the express goal of recruiting trust business from around the country, competing with states such as South Dakota that have been particularly successful in attracting trust business.² The far-reaching changes make it difficult for beneficiaries’ creditors (including ex-spouses) to reach discretionary trust interests and interests in trusts that include spendthrift provisions.

Accordingly, planners now counsel creating and extending trusts in situations previously not considered. Perhaps the most common scenario is a trust for a young beneficiary. Instead of providing that the trust terminates when the beneficiary reaches a certain age, clients should consider allowing the trust to last for the beneficiary’s lifetime, in order to keep inheritance separate from marital assets in case of divorce, and to provide Tennessee trust creditor protection. The beneficiary can be given the power to become sole trustee and several individual powers that approach the control of an outright distribution, including lifetime and testamentary limited powers of appointment and the power to veto distributions to others.

Retirement Accounts Payable to Trusts. IRAs are not exempt in bankruptcy from claims of a beneficiary’s/subsequent owner’s creditors under Bankr. Code §522(b)(3)(C), per the U.S. Supreme Court in Clark v. Rameker (2014). Accordingly, state law determines to what extent IRAs are exempt from a beneficiary’s/subsequent owner’s creditors inside and outside bankruptcy. It is unclear (to me, at least) what the interplay is between Tenn. Code Ann. §26-2-105(b) [IRAs exempt from creditors of owner and beneficiary] and §26-2-1111(1)(D) [IRAs not exempt to the extent that debtor can withdraw balance in lump sum]. Therefore, owners should think about ways to build creditor protection into beneficiary designations, including naming as beneficiary an “accumulation trust,” a “conduit trust” or a “trusteed IRA.”³
Tennessee Community Property Trusts. For married couples who live in separate property states, such as Tennessee, at the first of their deaths the decedent’s interest in joint property receives a step-up in basis for income tax purposes to fair market value under Internal Revenue Code section 1014(b)(6). In community property states, both spouses’ interests in the community property receive the basis adjustment, meaning all built-in capital gain (or capital loss) is eliminated, giving the surviving spouse better tax results if she sells the property. Married couples in Tennessee may seek the same potential tax benefit, through transferring assets to Tennessee Community Property Trusts.  

Marital Asset Protection Trusts/ Tenancy by the Entirety Trusts. Tenancy by the entirety (TBE) ownership protects assets from separate creditors of one spouse while both spouses are living, and from the deceased spouse’s separate creditors after the first death. Marital asset protection (MAP) trusts match those results and go one better. After the first spouse’s death, separate creditors of the surviving spouse may reach MAP trust assets only to the extent that the surviving spouse remains a beneficiary of the trust and possesses a non-fiduciary power to vest title to property in himself/herself individually. Even when the surviving spouse is the sole trustee, if she does not have the unilateral right in her individual capacity to force distribution of the property to herself, the trust property will continue to be protected from her creditors. Thus, married couples should consider transferring TBE property to MAP trusts, if for no other reason than to strengthen asset protection.  

Tennessee Investment Services Trusts. Several states allow individuals to create self-settled “domestic asset protection trusts” (DAPT). DAPT, generally requiring the use of a trustee in the state, purport to offer the same creditor protection available in offshore jurisdictions at a reduced cost, hassle and cross-border risk. Tennessee joined the DAPT states in 2007 with the creation of “Tennessee Investment Services Trusts” (TIST). In 2013, the legislature shortened the time to file a claim to set aside transfers to TIST as fraudulent and heightened the burden of proof. A creditor cannot bring a claim with respect to property comprising a qualified disposition unless he or she can prove by clear and convincing evidence that the settlor transferred the property with the intent to defraud that specific creditor. Early planning is critical to put as much time as possible between transfers to a TIST and a future debt or bankruptcy.  

A question with regard to DAPT/TIST is, what level of contact with the state is sufficient to cause the trust to be honored? The conflicts of laws issues raised in the few reported DAPT cases should be no threat to TIST created by Tennessee residents using assets located in Tennessee (and any other assets not physically located in a jurisdiction without DAPT), particularly if the trust has no trustees located outside Tennessee. It is unclear how well TIST will work for Tennessee residents funding the trusts with real property located in a non-DAPT state, or for residents of other states, particularly if funding the trust with assets physically located outside Tennessee.

Conclusion

Tennessee might have succeeded in reaching its goal of being a top trust jurisdiction. National commentator Steve Oshins ranks Tennessee the third most favorable state for creating trusts. Tennessee trust companies and banks continued on page 26
are trading on Tennessee’s favorable trust laws. Clients who previously would not have considered trusts in their estate plan, or would have included trusts primarily for death tax planning, should now consider one or more trust alternatives for divorce and creditor protection.  

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Notes

2. “Reason for Drafting SB 713/HB 713 and an Explanation of the Goals, Reasons and Source of the Provisions Contained Therein,” distributed to interested parties and legislators along with the draft legislation; see also http://SmartLawTN.com/big-changes-to-tennessees-uniform-trust-code-10-things-you-should-know.


4. See http://www.tba.org/journal/community-property-trusts (TBA membership required). Some have questioned whether such elective community property status will be honored for federal tax purposes. See, e.g., http://www.tba.org/journal/a-cautionary-tale-community-property-trusts. The author is aware of no case in the country definitively ruling whether elective community property treatment in a separate property state is effective for those living in separate property states, even though Tennessee has offered them for seven years and Alaska for 19 years.


6. See http://SmartLawTN.com/tis-trust-time-in-tennessee. Prior to this change, creditors had to challenge qualified dispositions as fraudulent pursuant to the limitations period in the Uniform Fraudulent Transfer Act, Tenn. Code Ann. 866–3–310, generally within four years. With this revision, if a person is a creditor when the qualified disposition to the TIST is made, the creditor has the longer of

(a) two years after the qualified disposition is made or

(b) six months after the creditor discovers or should have discovered the qualified disposition.

If the person becomes a creditor of the settlor after the qualified disposition is made, the action must be commenced within two years after the qualified disposition.

7. Bankruptcy Code Section 548(e)(1) provides a 10-year look back that allows the bankruptcy trustee to avoid transfers to DAPT (including TISTs) made “with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.” TIST settlors must execute solvency affidavits, but those documents can be self-serving and will not establish intent. Lawyers counseling potential TIST settlors should perform their own due diligence as to whether the TIST client has “gathering storm clouds.”
