

TENNESSEE ASSET PROTECTION TRUSTS

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Bryan Howard is a founding member of Howard & Mobley, PLLC. Bryan assists families whose net worth exceeds \$10 million with wealth transfer planning, tax reduction planning, charitable giving and asset protection planning. He also advises the owners of closely-held businesses with respect to tax and business succession issues and represents fiduciaries and beneficiaries with regard to trust and estate administration and litigation issues.

Bryan is certified as an Estate Planning Specialist in Tennessee. Bryan is listed in the Best Lawyers in America (2001-2010 editions) in both the Tax and Trusts and Estates categories, was selected as one of the top 100 Lawyers in the U.S. by Worth Magazine in 2006 and 2007, was selected as one of the Best Lawyers in Tax Law by Corporate Counsel magazine in 2007 and 2008, and was selected by Business Tennessee magazine as one of the best trusts and estates lawyers in Tennessee in 2008 and 2009. Bryan has the AV rating (highest available) for ethical standards and legal ability from Martindale-Hubbell's peer review ratings system.

Bryan frequently lectures and writes on estate planning and taxation topics. Recent articles include: "Fixing Broken Trusts: The Uniform Trust Code and Other Tools" published in the *Journal of Taxation of Investments* in 2008; "Asset Protection Trusts Come to Tennessee" published in the *Tennessee Banker* in 2007; "Trust Planning In An Uncertain Estate Tax Environment" presented to the 57th Annual Tennessee Federal Tax Institute in 2006; and "Installment Sales Involving Non-Grantor Trusts" published in *Estate Planning* in 2005.

Education

- B.S., Business Administration, University of California at Berkeley, 1979
- J.D., Vanderbilt University, 1983
- L.L.M., Taxation, University of Florida, 1984

Professional Activities

- Fellow, American College of Trust and Estate Counsel
- Numerous legislative activities, including, principal draftsman of the Tennessee Investment Services Trust Act of 2007, Member of Committee which drafted Tennessee Uniform Trust Code (2004 and 2007) and Member of Tennessee Bar Association's Probate Study Committee, which reviews and recommends legislation involving trusts and estates in Tennessee
- Former Chairman (1994 & 2006), Estate Planning Committee, Nashville Bar Association
- Former Chairman (2004), Tax Committee, Nashville Bar Association

Civic and Other Activities

- Board Member and Former President, Guardianship and Trust Corporation of Tennessee
- Trustee and Former President, Tennessee Federal Tax Institute
- YMCA Foundation of Middle Tennessee – Member of Professional Advisory Committee
- Nashville Symphony – Member of Legacy Advisory Council

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TENNESSEE ASSET PROTECTION TRUSTS

Roger Ramrod is an all-pro middle linebacker for the Tennessee Titans. After a heartbreaking loss to the Pittsburgh Steelers, Roger stops at a local nightclub to take his mind off of the loss. Roger strikes up a conversation with a young lady who asked for his autograph. The lady's boyfriend becomes jealous and approaches Roger with his gun drawn. A fight ensues and gunshots kill one patron of the nightclub and paralyze another patron for life. Several months later, a jury awards a \$10 million judgment against Roger for his part in instigating the fight. The Titans release Roger and no other team is willing to sign Roger.

The story in the prior paragraph is fictional. Even if you believe this story is farfetched, you should be concerned about what can happen to your clients. Athletes and entertainers are exposed to lots of situations that put their assets at risk. They need your advice regarding measures that may be taken to protect their assets.

There are several techniques that can be utilized to protect a person's assets. This paper will focus on the use of irrevocable trusts for asset protection.

A. TRUSTS ESTABLISHED BY SOMEONE OTHER THAN THE BENEFICIARY

Tenn. Code Ann. § 35-15-502 prohibits a creditor of a trust beneficiary from reaching a beneficiary's interest in a "spendthrift trust" prior to its receipt by the beneficiary. In order to obtain this protection, the trust agreement needs to state that it is a spendthrift trust. Except for Tennessee Investment Services Trusts, discussed below, the trust must be created and funded by someone other than the beneficiary in order to obtain this spendthrift trust protection.

1. LIFETIME TRUSTS FOR CHILDREN – Significant inheritances for children should be left in lifetime trusts, in order to protect the children's inheritances from divorce and creditors. The standard way of leaving an inheritance is to give the inheritance to the recipient outright (not in trust), unless the recipient is too young to handle the funds or has "disabilities."¹ Here is an example of the standard way of leaving an inheritance.

¹ The list of "disabilities" runs the gamut of human frailties, from medical or mental disabilities to substance abuse to bad marriages to spendthrift spending habits. Since the Beneficiary Controlled Trust is designed to have the beneficiary serve as his or her own Trustee, the BCT is not appropriate in situations where the beneficiary has disabilities and needs a third person as Trustee.

Daddy Warbucks leaves a Will that provides for his ward Annie...

“If Annie has reached age 40 at my death, her inheritance shall be distributed to her outright and free of trust. If Annie has not reached age 40, her inheritance shall be held for her in trust. The Trustee shall distribute to Annie any income and principal the Trustee determines to be necessary for Annie’s health, education, maintenance and support at any time. When Annie reaches age 30, the Trustee shall distribute $\frac{1}{3}$ of the trust principal to Annie. When Annie reaches age 35, the Trustee shall distribute $\frac{1}{2}$ of the trust principal to Annie. When Annie reaches age 40, the trust shall terminate and the Trustee shall distribute all remaining assets of the trust to Annie.”

Look familiar? We have all seen this approach and its variations in numerous Wills or trust agreements that we encounter. The standard way ultimately results in a bad swap--the loss of the benefits of trust ownership in exchange for the problems of outright ownership.

There are two problems with outright ownership. First, the property becomes available to the creditors of the beneficiary immediately upon an outright distribution. Conversely, as long as property is held in a properly designed irrevocable trust, it is protected from the creditors of the beneficiary, including spouses in the context of divorce. Second, the property and all of its growth and income needlessly increase the size of the beneficiary’s estate. Upon the death of the beneficiary, this may cause an estate tax that otherwise could have been avoided using a trust that is controlled by the beneficiary as controlling trustee.

While the inheritance is in trust, it is protected: if the beneficiary is sued, the inheritance is not subject to garnishment or execution because the funds are in a spendthrift trust; if the beneficiary goes through a divorce, the trust assets will not be considered marital property and divided with the ex-spouse. Furthermore, the trust’s spendthrift status protects the inheritance from claims for alimony. If the beneficiary marries, then dies, the trust assets are protected from the claims of the surviving spouse for elective share, year’s support, homestead, exempt personal property and other marital rights.

Bottom line: the standard way forces the inheritance out of a safe place (the trust) and into a not-so-safe place (the beneficiary’s personal name) simply because the beneficiary reaches some specified age. Bad things (divorce, lawsuits, remarriage without a pre-nup, estate taxes) can happen to good people.

When an individual, a parent for example, wants property distributed to his or her beneficiary either outright or upon reaching a specified age, in most instances the parent does not want the beneficiary to spend all the property as soon as they reach a certain age; rather, the parent wants the beneficiary to have control over the property once the beneficiary reaches the specified age. This objective can be accomplished by using a trust and naming the beneficiary as managing trustee rather than requiring that the property be distributed. There are not many rights that the beneficiary can have owning the property outright that the beneficiary cannot also have as trustee.

Many individuals are reluctant to use trusts due to their mistaken belief that a trust must be designed to keep the trust property away from the beneficiaries. A properly designed trust can allow the beneficiary to control the trust property, yet provide tax planning and asset protection for the beneficiary that the beneficiary does not have with outright ownership. This concept is called the **Beneficiary Controlled Trust**. The Beneficiary Controlled Trust is a trust designed to give the beneficiary of the trust control over the trust, most notably by the simple step of naming the beneficiary as the Trustee of the trust. This concept enables the beneficiary to have his or her cake (control, actually) and eat it too---the beneficiary's trust funds receive the benefits of trust ownership while giving the beneficiary the control over and access to the trust funds. It is a superior alternative to the standard way of leaving an inheritance.

Comparison of Rights of Outright Ownership With Rights of Beneficiary Controlled Trust.

| <i>Rights of Outright Ownership</i> | <i>Powers the Trustee/Beneficiary can have in a Beneficiary Controlled Trust (“BCT”)</i> |
|---|---|
| Right to manage and control property, choose investments, investment managers, etc. | Trustee/beneficiary of a BCT trust has all the administrative powers of any other trustee, including the power to manage and control the trust property, choose investments, investment managers, etc. Trustee/beneficiary can also have power to select, remove, and replace successor Trustees and/or Co-Trustees. |
| Right to use the income earned by the property. | Trustee/beneficiary can use trust income for health, education, maintenance and support of beneficiary and beneficiary’s family (cannot use income to discharge duty of support to dependents). ² |
| Right to use principal. | Trustee/beneficiary can use trust principal for health, education, maintenance and support of beneficiary and beneficiary’s family (cannot use principal to discharge duty of support to dependents). ³ Trustee/beneficiary can also have annual right to withdraw 5% of trust principal. This withdrawal right can be used for any purpose, not just for health, education, maintenance and support. |
| Right to determine who gets property when you die | Trustee/beneficiary can have a power of appointment to determine who gets trust property when Trustee/beneficiary dies. (This power is called a “limited” power of appointment in tax parlance.) |
| “Right” to lose it to a creditor, or to an ex-spouse, or to a surviving spouse’s marital rights when you die. | SORRY!!!! This is a spendthrift trust. The property is protected from creditors, ex-spouses and the rights of surviving spouses. |
| “Right” to lose approximately 50% of its value to estate and inheritance taxes when you die. | SORRY UNCLE!!!! The assets in the trust are not subject to estate and inheritance taxes when Trustee/beneficiary dies, only to generation skipping taxes IF APPLICABLE. |

² In order to provide a broader distribution standard and more flexibility, an independent co-trustee can be appointed by the beneficiary to make distributions and other tax sensitive decisions. The beneficiary can be given the power to remove the independent co-trustee, with or without cause, and name a successor independent co-trustee.

³ Same as footnote 2 above.

2. GIFTS TO SPOUSAL TRUSTS

a. **Marital Trusts** – rather than leaving your spouse’s inheritance to him or her outright, consider leaving it to a marital trust controlled by your spouse. As a general rule, if the client’s estate exceeds \$1 million, the marital trust should be drafted to qualify for the Federal and Tennessee estate and inheritance tax marital deductions⁴.

b. **Cristofani Trusts** – annual exclusion gifts to children and grandchildren can be made to a trust of which the spouse is a discretionary beneficiary. The trust can be structured to provide “Crummey” withdrawal rights of \$26,000 per year for children, in-laws and grandchildren, and the lesser of: (i) \$13,000; and the greater of (ii) \$5,000 or 5% of the value of the trust assets, for the spouse. Whatever is not withdrawn will remain in a trust held for the primary benefit of the spouse during his or her lifetime. The other “Crummey” beneficiaries will be secondary discretionary beneficiaries. Following the spouse’s death, the trust will pass to issue in accordance with the trust provisions or pursuant to the spouse’s exercise of a nongeneral power of appointment.

The spousal interest makes the trust a grantor trust for income tax purposes while both spouses are alive. Grantor Trust status requires the Donor to pay all federal income taxes on trust income and allows certain transactions to occur between the Donor and the Trust (such as installment sales of discounted assets) without triggering adverse income tax consequences.

c. **Inter Vivos Tennessee QTIP Trusts** - A substantial benefit can be obtained by making a lifetime gift of the \$1,000,000 federal gift tax exemption amount because appreciation of the gifted property between the date of the gift and the donor’s death can escape federal transfer taxes. The author frequently hears the complaint that Tennesseans are unwilling to make such a gift because it will require the payment of Tennessee gift taxes. A Tennessee QTIP Trust provides an opportunity for making a substantial lifetime gift without paying Tennessee gift tax. A Tennessee QTIP Trust is a trust that would qualify for the federal gift tax marital deduction but for which the donor elects not to make a QTIP election on the federal gift tax return. The donor does make the QTIP Trust election on the Tennessee gift tax return. There is no requirement that a federal QTIP Trust election be made in order to qualify for the Tennessee QTIP Trust election.

Rather than requiring income to be paid to the spouse, the author recommends that the spouse be given the right to withdraw income. This qualifies for the gift tax marital deduction under Treas. Reg. Section 25.2523(e)-1(f)(8). There are two benefits from using the right to withdraw income as opposed to the

⁴ A detailed explanation of the marital deduction qualification rules is beyond the scope of this paper. The most substantive requirements are for the spouse to receive all income and to limit the potential beneficiaries of the trust to the spouse during the spouse’s lifetime.

mandatory payment of income. First, to the extent income remains in the trust, it will escape federal transfer tax. The second benefit is that during the period the donee spouse survives the donor spouse, the donee spouse will be required to pay federal income taxes attributable to trust income even though the income remains in the trust. Thus, the trust is able to grow in value on a pre-tax basis. Under Internal Revenue Code Section 678(a)(1), the donee spouse will be taxed on all trust income whether or not withdrawn. Furthermore, under Internal Revenue Code Section 678(a)(2), the donee spouse will gradually become the grantor of the trust to the extent that the power to withdraw lapses. As the donee spouse gradually becomes the grantor of the trust, he or she will be able to pay tax on a greater portion of the capital gains of the trust in addition to paying tax on all of the ordinary income of the trust.

During the donor spouse's lifetime, the trust will be a grantor trust as to ordinary income under Internal Revenue Code Section 677. Capital gains will also be taxed to the donor spouse if the Trustee has discretion to pay principal to the donee spouse. This will allow the donor spouse to be taxed on all trust income, including capital gains, and will allow certain transactions to occur between the donor spouse and the trust (such as installment sales of discounted assets) without incurring adverse income tax consequences.

The donor spouse should not have a successor life estate or discretionary principal interest following the death of the donee spouse. This would cause estate tax inclusion under Internal Revenue Code Section 2036.

The downside with a Tennessee QTIP Trust occurs when the donee spouse predeceases the donor spouse. If the value of the trust upon the donee spouse's death exceeds the Tennessee inheritance tax exemption (currently \$1,000,000), the donee spouse's estate will incur Tennessee inheritance tax. This means that some transfer tax will be paid prior to the death of the survivor. Because the lifetime Tennessee QTIP Trust will exhaust the donee spouse's Tennessee inheritance tax exemption, the donee spouse's Will should establish a testamentary Tennessee QTIP Trust (as opposed to a traditional credit shelter trust) for the donee spouse's federal estate tax exemption amount. Due to the potential Tennessee inheritance tax upon the death of the donee spouse, and the necessity of the donee spouse's establishment of a testamentary Tennessee QTIP Trust, it may be advisable for the spouse with the shortest life expectancy to be the one who establishes the lifetime trust. However, the greatest benefit from accelerating the use of the federal gift tax exemption will occur if the trust is established by the spouse with the longest life expectancy.

3. BENEFICIARY DEFECTIVE TRUSTS FOR NEW BUSINESS OPPORTUNITIES

Assume that one of your clients intends to start a new business, or sell a new product or enter a new geographic territory for an existing business. Your client realizes that he could give this business opportunity to an irrevocable trust for his children or his spouse, but would prefer to maintain ownership of the business opportunity. The client should consider asking his parent or spouse to set up a trust for the primary benefit of the client, with the client as trustee. The trust would be funded with \$5,000. The client would have 30 days to withdraw the original contribution to the trust. If necessary, additional funds can be loaned to the trust by the client, his or her spouse, or by a third-party loan guaranteed by the client. The trustee would have discretion to make distributions to the client and his or her descendants for their health, education, maintenance and support. The client would have a testamentary limited power of appointment.

If the business opportunity proves to be successful, the value will have been created in a trust that will not be included in the beneficiary's estate for estate tax purposes. The trust will be a grantor trust as to the client for income tax purposes, which simplifies income tax reporting and allows transactions to occur between the client and the trust without adverse income tax ramifications.

4. TRUST IN LIEU OF LLCs FOR ASSET PROTECTION

Assume that your client wants to acquire real estate that she will lease to her own business or to third parties. Your client would like to utilize a LLC for liability protection but decides that the Tennessee franchise and excise taxes would be too substantial. This may be the perfect opportunity for a beneficiary defective trust established for your client by her parent or spouse. Alternatively, the client can establish an Inter Vivos QTIP Marital Trust that would acquire the interest in the building. The trust will provide liability protection to the trustee and the beneficiary that is comparable to an LLC. The Trust will not be subject to franchise and excise tax. An added benefit is that the trust assets should be exempt from the beneficiary's creditors.

B. TRUSTS ESTABLISHED BY THE BENEFICIARY

Tennessee is one of twelve states that allow a person to establish a trust for his or her own benefit and have the assets of the trust protected from the person's future creditors. Traditionally, states have not extended protection from creditors to a trust that is self-settled. As American society has grown more litigious, interest in providing a mechanism for asset protection has developed. Domestic asset protection trusts have been part of the answer. Delaware and Alaska started this trend in 1997.

Effective as of July 1, 2007, Tennessee enacted the "Tennessee Investment Services Act of 2007" (the "Act"), which permits the creation of self-settled asset protection trusts in Tennessee. The economic motivation for the legislation was to help banks and trust companies retain trust business that would otherwise leave the state and to attract business from customers in other states. Tennessee became the first Southeastern state to have this type of legislation. Tennessee's legislation is based on the Delaware statute, although it contains certain differences.

A settlor can create a Tennessee Investment Services Trust or Asset Protection Trust ("APT") by transferring assets to an irrevocable trust that contains a spendthrift clause and incorporates Tennessee law to govern the validity, construction, and administration of the trust. At least one of the trustees of the APT must be an individual who is a resident of Tennessee or a Tennessee corporate fiduciary. The Tennessee trustee must "materially participate" in the administration of the APT. Material participation includes holding some of the trust property in Tennessee, maintaining records for the trust on an exclusive or non-exclusive basis, or preparing or arranging for the preparation of fiduciary income tax returns for the trust. The settlor may not be a trustee.

A settlor of an APT is permitted to retain certain rights without jeopardizing the spendthrift protection, including: (i) the right to be a discretionary beneficiary of income and principal distributions; (ii) the power to veto a distribution from the trust; (iii) a testamentary limited power of appointment; (iv) the right to remove and appoint trustees; and (v) the right to act as investment advisor to the trust. Settlers should not retain powers and interests that are not specifically authorized by the Act. For example, the trust agreement should not allow the settlor to expressly have the right to be reimbursed for income taxes, nor for his estate to be reimbursed for estate or inheritance taxes attributable to the trust.

Prior to the transfer of assets to the APT, the settlor must sign an affidavit stating that: (i) the transfer will not render the settlor insolvent; (ii) the settlor does not intend to defraud any creditors by the transfer; and (iii) no court or other proceedings are pending against the settlor other than those identified in the

affidavit. In addition, the settlor must affirm that the settlor does not contemplate filing for bankruptcy, and that the property transferred to the APT is not derived from any unlawful activity. The attorney or advisor should perform some due diligence in connection with the affidavit. Exposure for the attorney, advisor or trustee of the APT is limited under the Act itself, but the attorney or advisor should always follow a screening procedure (including the preparation of a solvency analysis) to ensure that he or she is not participating in a fraudulent transfer.

Similarly to all the domestic APT statutes, creditors can reach the trust assets if the transfer of assets to the APT was a fraudulent transfer. A fraudulent transfer claim must be brought pursuant to the Tennessee Uniform Fraudulent Transfer Act. A creditor whose claim arose prior to the transfer to the trust has four years after the transfer was made or, if later, one year after the transfer was or could have reasonably have been discovered by the claimant. A person who establishes an APT should inform existing creditors of the APT. Otherwise, the statute of limitations may remain open beyond four years for a pre-transfer creditor. A creditor that arises after the transfer to the APT must bring a claim within four years after the transfer was made and must prove that the transfer was fraudulent as to such creditor.

Federal bankruptcy law contains an additional hurdle for APTs. Bankruptcy trustees may sue to avoid a transfer to a self-settled trust made within ten years before the date of the filing of the bankruptcy petition if, in addition to other technical criteria, the transfer was made “with actual intent to hinder, delay or defraud” any creditor to which the debtor was or became indebted on or after the date that such transfer was made. Due to uncertainty regarding the interpretation of this law, a settlor should avoid filing for bankruptcy for ten years after transferring assets to an APT, even if the transfer was made without fraudulent intent and the settlor subsequently experienced a reversal of fortunes.

If a beneficiary of an APT fails to pay child support, alimony, or a court ordered property settlement to a spouse who was married to the beneficiary prior to the beneficiary’s transfer of property to the APT, the ex-spouse can bring an action against the Trustee to satisfy the past due payments. The statute does not recognize any other “exception creditors.” This short list of “exception creditors” makes Tennessee one of the best states in which to establish an APT.

Creditors may not bring an action against the trustee, trust protector, trust advisor, or other fiduciary of an APT or any attorney or other person involved in the drafting, execution, funding, and administration of the trust. The Act also protects those involved in drafting, executing, funding, and administering limited partnerships and limited liability companies, the interests in which are subsequently transferred to the APT.

Most APTs will be taxed as grantor trusts for federal income tax purposes. This means that the settlor will be taxed on all of the trust income. The author recommends that the APT use the settlor's Social Security number as the taxpayer identification number for the trust so that the trust will not need to file a federal income tax return. The APT should file a Tennessee income tax return for interest and dividend income. In certain instances, out-of-state settlors may structure the trust as a non-grantor trust in order to reduce state income taxes in their state of residence.

Most APTs give the settlor a testamentary limited power of appointment in order to make gifts to the trust incomplete for gift tax purposes. Because the gift is incomplete, gift tax will not be incurred upon the funding of the trust. However, the retained testamentary limited power of appointment will cause the trust to be taxed for estate and inheritance tax purposes upon the settlor's death. Some APTs are structured as completed gifts with the expectation that the APT will not be subject to tax in the settlor's estate.

The APT needs to be carefully integrated with the client's other estate planning documents. As an example, if the trust is drafted as an incomplete gift trust, estate and inheritance taxes may be owed on the property held in the APT upon the settlor's death. The tax apportionment clause in the settlor's Will needs to be drafted to take this issue into consideration.

The author has been surprised by the profile of the clients who have decided to implement APTs. Relatively few settlors of these trusts have been professionals in high risk professions such as medicine. Instead, the most frequent settlors of APTs have been wealthy business owners. Even though their businesses are conducted as corporations or LLCs, these business owners fear that a jury will award substantial damages against them for injuries sustained as a result of some transaction between their business and a customer. The second most common settlors of these trusts have been young adults who do not want to lose assets that have been gifted to them by parents and/or grandparents. These young adults have been encouraged to establish APTs by their parents in order to protect assets from future spouses and other potential creditors.

The Act amended Tennessee's rule against perpetuities. Any trust (not just APTs) created after July 1, 2007 can last for 360 years if a testamentary power of appointment is granted to at least one member of each generation of beneficiaries who are beneficiaries of the trust more than ninety years after the creation of the trust. Tenn. Code Annotated § 66-1-202(f). The permissible appointees of the power of appointment must at least include all descendants of the beneficiary. Extending the rule against perpetuities allows property to pass for the benefit of future generations without the payment of generation-skipping tax.