

WHITE PAPER



FOR TRUSTS, TENNESSEE IS THE PLACE TO BE

Tennessee is one of the most trust-friendly jurisdictions in the country. In fact, the state considers this position to be a competitive advantage to lure more business here. Because trusts can be excellent vehicles for protecting assets, minimizing taxes and providing for a structure for distributions to beneficiaries, even those with modest wealth should consider utilizing trusts in their estate planning and review the advantages that Tennessee trust law provides in the administration of the trusts.



BY **BROOK LESTER, CPA**
PRINCIPAL & CHIEF WEALTH
STRATEGIST



& **ROB LINEBERGER**
GENERAL COUNSEL/
SENIOR FIDUCIARY OFFICER

continued on next page >

**DIVERSIFIED
TRUST**

diversifiedtrust.com

This paper will explore the advantages of Tennessee trust law in detail, including flexible decanting and other trust modification rules, robust asset protection provisions, expanded protection for trustees (think directed trusts versus delegation by a trustee), equitable adjustment and unitrust conversion statutes, and a welcoming environment for private family trust companies.

History

In 2004, Tennessee adopted the Tennessee Uniform Trust Code (the “Code”)¹. Subsequent to enactment, the Tennessee Legislature has continued to make enhancements to the laws governing trust in Tennessee. In 2007, the Legislature passed the Tennessee Investment Services Act (Tennessee’s self-settled trust statute). In 2010, the Community Property Trust Act was passed and in 2013 legislation was passed that allowed for multi-party administration of trusts. These modifications to the Code have intentionally created divergence from the Uniform Trust Code and related restatements. This divergence at times is significant. Additionally, Tennessee’s Prudent Investor Act, passed in 2002, encourages the use of modern portfolio theory in managing trust assets and defines how trust investment management may be delegated to an investment manager. This gives greater flexibility to trustees and eliminates rules prohibiting trustees from making certain types of investments. In 2013, Tennessee’s trust law was modified significantly to make it even less likely that creditors can access trust funds² and enhanced the Code’s decanting provisions allowing a trust that was created in another state to be decanted if the original trust is being administered in Tennessee³. Tennessee only recognizes two “exception creditors” (child support obligations and claims for alimony/spousal support or division of marital assets) and the statutory limitations that creditors face make recovery difficult. We are seeing more and more planners now advising clients to create trusts in situations where they weren’t previously considered, such as setting up trusts to protect a young beneficiary from divorce or creditors, using self-settled trusts as a substitute for an ante-nuptial agreement.

Advantages of Trusts in Tennessee

There are several factors that help make Tennessee an attractive jurisdiction to establish and maintain trusts.

Responsive Tennessee Legislature

As mentioned earlier, the legislature has added or modified its Code, and we believe the legislature is likely to perpetuate this environment to attract more trust business to the state.

Settlor's Intent is the Lodestar

Protecting settlor intent is a primary objective of the statutes comprising the Tennessee Uniform Trust Code. To the extent that it is constitutionally allowable, Tennessee law permits settlors to design trust instruments as they see fit to dispose of their assets. The settlor's intent, is seen as the lodestar by which a trust administered in Tennessee is to be interpreted.⁴

Overall, there are fewer mandatory default rules under the Tennessee Uniform Trust Code than in the Uniform Trust Code. Tennessee courts are to give maximum effect to the principle of freedom of disposition and the enforceability of trust instruments.⁵

Flexible Decanting

Tennessee allows the trustee of certain irrevocable trusts to modify the way a trust is administered by distributing – or “decanting” – trust assets from the original irrevocable trust to a second irrevocable trust with different terms. According to Steve Ochins, a national expert on trust law, Tennessee has the third-most flexible decanting statute (T.C.A. 35-15-816(b)(27)) in the country, behind only Nevada and Alaska.

A trust created in another jurisdiction can be decanted as long as the original trust is being administered in Tennessee. A new trust created by the act of decanting enjoys the benefits derived from Tennessee's trust-friendly laws. The new trust may also have a different encroachment standard than the prior trust and may grant the beneficiary a power of appointment that was not available under the terms of the prior trust.

Additionally, a decanting allows for a change of taxing jurisdictions, which may eliminate income tax exposure from the jurisdiction in which the former trust was administered.

Under the Code, a decanting cannot extend the perpetuities period of the original trust.

AS AN EXAMPLE: Original trust provides that Trustee may encroach upon principal and make distributions of principal to a proper object of the exercise. This trust has a perpetuities period of 90 years. If Trustee exercises its decanting power, the new trust's perpetuities period cannot be extended to 360 years (the current perpetuities period in Tennessee) but will remain at 90 from the date of original trust.

Additional Trust Modification Tools

Decanting isn't the only tool that can be used to modify a Tennessee trust. Others include:

- **Non-judicial Settlement Agreements**

Until 2004, it was very difficult to modify an irrevocable trust in Tennessee without going to court. Today, as a result of the Tennessee Uniform Trust Code, trustees and beneficiaries may enter into binding agreements with respect to any matter involving the trust without judicial intervention, as long as the agreement does not violate a material purpose of the trust. Non-judicial Settlement Agreements may deal with a variety of issues:

- **Resignation or appointment of a trustee and the determination of a trustee's compensation;**
- **Interpretation or construction of the terms of the trust;**
- **Approval of a trustee's report or accounting;**
- **Direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power;**
- **Transfer of a trust's principal place of administration;**
- **Liability of a trustee for an action relating to the trust;**
- **Extent or waiver of bond of a trustee;**
- **Governing law of the trust;**
- **Criteria for distribution to a beneficiary where the trustee is given discretion.⁶**

IMPORTANT NOTES AND DISCLOSURES

This White Paper is being made available for educational purposes only and should not be used for any other purpose. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Diversified Trust Company, Inc. believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based. Opinions expressed in these materials are current only as of the date appearing herein and are subject to change without notice. The information herein is presented for illustration and discussion purposes only and is not intended to be, nor should it be construed as, investment advice or an offer to sell, or a solicitation of an offer to buy securities or any type of description. Nothing in these materials is intended to be tax or legal advice, and clients are urged to consult with their own legal advisors in this regard.

- **Merger of Trusts**

If no provisions for decanting apply to a specific trust, a merger may still accomplish the goal of the parties. Tennessee's Code allows an existing trust to merge with a newly created trust to take advantage of Tennessee trust law. A trustee may combine two or more trusts into a single trust or divide a trust into two (2) or more separate trusts if the result does not impair the rights of any beneficiary or adversely affect the achievement of the purposes of the trust.⁷

EXAMPLE: A beneficiary is about to turn 18 and become eligible to access his trust fund. However, the beneficiary has just completed a drug rehab program and is clearly not ready to responsibly manage those funds. Decanting or other trust modifications may be used to make changes in the trust provisions to prevent the beneficiary from accessing the funds until he is fully ready to do so.

Powerful Asset Protection Statutes

Tennessee has several statutes designed to protect trust assets from the claims of creditors:

- **Tennessee Investment Services Act Trusts (TIST)**

The adoption of the Tennessee Investment Service Act of 2007 (otherwise known as domestic asset protection trusts) represented a significant change to Tennessee common law, which generally had prohibited an individual from protecting assets from creditor claims by creating a trust for his or her own benefit. Tennessee's statute (T.C.A. 35-16-101 to 112)) allows individuals to create self-settled, irrevocable trusts. For a trust to qualify as a TIST, the trust must meet the following requirements:

- **The trust must expressly incorporate Tennessee law for purposes of validity, construction and administration**
- **The trust must be irrevocable**
- **The trust must contain a spendthrift clause**
- **The trust must have a qualified trustee who**
 - **is a Tennessee resident or corporate trustee licensed under Tennessee law**
 - **must perform certain duties — i.e. custody of assets, tax preparation, trust administration**
- **The Grantor/Settlor must execute a qualified affidavit**
- **The Grantor/Settlor cannot be the trustee**

In addition to protecting assets, TISTs also have other benefits. They can be modified fairly easily,

offer enhanced protection for trustees, have significant tax advantages and are relative easy to set up. TISTs may offer the same creditor protection available in offshore jurisdictions with lower cost, less hassle and fewer cross-border risks. Alimony/spousal support and child support obligations are the only exception creditors that cannot be avoided with a TIST.

Tennessee has taken additional steps to make it more difficult to contest the transfer of money into a TIST to protect against creditors. In 2013, the state legislature shortened the time to file a claim to set aside transfers to TISTs as fraudulent and heightened the burden of proof. Pre-transfer creditors must challenge a trust and bring a claim within either two years from the date of transfer of property to the trust or six months from the date of the creditor's having discovered the transfer, whichever is later.

To make it even more difficult for creditors, many attorneys are now recording affidavits of transfers in applicable counties, making the transfers to the trust public record which is notice. What's more, even if a claim is filed within the statute of limitations period, the creditor must show by clear and convincing evidence that the transfer was made for the purpose of defrauding the specific creditor.

A TIST may be a particularly good choice for certain individuals:

- **Young adults who come into a large inheritance who need protection from financial irresponsibility**
- **Real estate developers who will potentially exposed to severe downturns in real estate markets**
- **Doctors who seek protection from malpractice suits**

TISTs do have some potential pitfalls, however. They are highly restrictive, and the Tennessee Supreme Court has yet to rule on their validity, creating a degree of uncertainty.

- **Dynasty Trusts**

Dynasty trusts are created to pass wealth from generation to generation without incurring transfer taxes. The assets placed in the trust (plus any increase in their value over the years) are subject to federal gift tax just once, when they transferred to the trust. On the other hand, if you left a large sum of money to your children without a trust, it would be subject to the estate tax each time it is passed from generation to generation if subsequent generations do not avail themselves of a trust.

Tennessee is ranked as the third-best jurisdiction for dynasty trusts by expert Steve Oshins, particularly because of its favorable perpetuity rule, which is a 360-year period.

One possible downside — dynasty trusts are irrevocable, so neither you nor your descendants

can alter the terms of the trust if circumstances change (depending upon terms decanting may be available).

- **Tennessee Community Property Trusts (TCPT)**

Tennessee is not a community property state. However, married couples in Tennessee may still realize the same tax benefit as couples in community property states by transferring their assets to a TCPT⁸. The TCPT is designed to provide both spouse's interest in joint property transferred to a TCPT a full step up in basis at the death of the first spouse to die. Additional potential benefits may be the divisions of assets in the TCPT at the death of the first spouse to fund a credit shelter trust and potentially obtain fractional discounts upon the death of the survivor. These potential benefits would reduce federal estate taxes.

Tennessee is one of only two states that allow non-residents to convert assets from separate property to community property. TCPTs also can be appealing to non-residents who live in jurisdictions that impose income tax on capital gains and rental income.

There are potential downsides, however. Forming TCPTs can be tricky, since asset transfers could be considered a taxable gift between spouses. Plus, the IRS has still not made it clear how it will treat Community Property Trusts. The TCPT must include certain language, have at least one trustee who is a Tennessee resident or a Tennessee bank or trust company as trustee, must be signed by both spouses and must contain language that gives notice of the consequences of the trust. There may be tax advantages to a TCPT, but a Tenancy by the Entirety Trust (below) may be a better choice for liability protection in Tennessee.

- **Tenancy by the Entirety Trusts (TBE)**

A TBE trust⁹ can be created by a husband and wife (or by each spouse if other spouse is a permissible beneficiary) to protect the assets of one spouse while both spouses are living, and from the deceased spouse's separate creditors after the death of the first spouse to die.

Basically, it stipulates that a husband and wife as a unit have the right to the current use and enjoyment of their assets and that an individual spouse's creditor cannot reach those assets. A home, the most common asset held in a TBE trust, can be protected simply by indicating on the deed that the parties are married.

A form of a joint self-settled revocable trust, a TBE trust can be formed by Tennessee residents and non-residents alike, as long as it is administered in Tennessee. Additionally, any property held by the trust must have been Tenancy by the Entirety property prior to its conveyance to the trust. Requirements of a valid trust include:

- **The trust can only be created by married spouses and the protection only lasts while they remain married.**
- **The trust must be revocable by either spouse acting alone or both spouses acting together.**
- **The property (or its proceeds) must remain in the trust.**
- **Both spouses must be permissible current beneficiaries while living.**
- **The trust instrument, deed or other instrument of conveyance must reference TCA Section 35-15-510 as applying to the property and its proceeds.**

A TBE trust may not be unilaterally severed by a spouse. To sell or gift assets in the trust, both spouses must be in agreement. Also, these trusts offer protection only from creditors of the first spouse to die (creditors of the surviving spouse may attach assets of the trust) and do not protect the assets of one spouse from the other spouse, nor do they shield assets from creditors' claims if the husband and wife are joint creditors.

• **Retirement Accounts Payable to Trusts**

Trusts can be effective tools to protect assets in retirement accounts from creditors. Tennessee law allows three different types of trusts to be the beneficiary of an IRA:

- **ACCUMULATION TRUST — The Required Minimum Distribution (or other IRA distributions) is distributed from the IRA to the trust, but the trustee has the option to “hold” the distribution and accumulate it with the principal of the trust.**
- **CONDUIT TRUST — All distributions that come into the trust on an annual basis must be distributed out in the same year to the rightful beneficiary. The trust is merely a “conduit” to hold the IRA for the benefit of the beneficiary.**
- **TRUSTEED IRA — The holder of the IRA can specify contingent beneficiaries, which cannot be challenged by the primary beneficiary.**

State Income Tax Advantages For Trusts

No Tennessee income tax is imposed on non-resident beneficiaries of a trust administered in Tennessee.¹⁰

Plus, the Hall Tax, which taxes dividends and interest received by a trust with resident beneficiaries, is being gradually phased out with full repeal slated for 2021.

Increased Protection for Trustees

As part of the overhaul of Tennessee's trust law in 2013, trustees of directed trusts are protected from the decisions made by investment advisors, special trustees, trust protectors and other influencers. This can be especially beneficial for family members who serve as trustees, removing what can be a sizable legal burden. It also frees the settlor to pick the best resource for each specific aspect of the administration of a trust.

For some trusts established before 2013, this protection for trustees can be added through a trust modification agreement, non-judicial settlement agreement or decanting the old trust into a new trust.

Note that this law does not protect trustees from their own administrative errors.

Strong Unitrust Conversion Statute

A trustee may alter a "net income trust" to a "unitrust" if the trustee believes it to be prudent. A conversion to a unitrust in a low interest rate environment will be beneficial to an income beneficiary. The trustee undertaking a unitrust conversion, may benefit beneficiaries in Tennessee. A conversion to a unitrust allows the income beneficiary of the converted trust to receive a unitrust distribution in an amount between 3% and 5% of the total market value of the trust valued annually.

A unitrust conversion may better align the needs of an income beneficiary, who typically wants a trustee to select investments that deliver high income, and remainder beneficiaries, who are more likely to prefer investments that appreciate over time. When distributions are based on the value of the trust, growth will increase distributions to the income beneficiary while also benefiting the remainder beneficiaries.

EXAMPLE: Assume that an irrevocable trust with \$1 million of assets generates net income of \$25,000 per year. If the trust is converted to a 4% unitrust, the annual distributions will increase to \$40,000.

Excellent Jurisdiction for Private Family Trust Companies

A private family trust company (PFTC) is a state-chartered entity providing fiduciary services to members of a family. The trust is owned entirely by the family and is not permitted to do business with the public.

An increasing number of families with assets of \$100 million or more are setting up their own private trust companies in Tennessee. PFTCs also give families more control over the trust's investment decisions compared to banks. The statutory and regulatory frame work for PFTCs is favorable in Tennessee.

A PFTC is different from a “family office” in that PFTC may serve as a fiduciary under state law.

Conclusion

Tennessee has taken significant steps to attract trusts and trust business to the state. The legislature and other leaders see the state's trust-friendly environment as a powerful economic development tool. Jobs are being created because of it. In fact, to maintain the state's leadership position as a trust-friendly jurisdiction, Tennessee evaluates the effectiveness of the state's trust and private family trust company laws annually. All this means that it is highly unlikely that the climate will change anytime soon.

However, as mentioned earlier, there are still potential pitfalls to setting up a trust, even in a state like Tennessee. Property, tax and asset protection laws must be taken into account, the state Supreme Court has yet to rule on certain aspects of trusts and the IRS's attitude regarding the taxability of certain trust transactions is still not completely clear.

THE BOTTOM LINE: Seek advice from trust professionals as well as attorneys who are well-versed in Tennessee trust law prior to creating a trust.

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333

GREENSBORO

701 Green Valley Road, Suite 300
Greensboro, NC 27408
Phone: 336.217.0151

MEMPHIS

6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979

NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302

FOOTNOTES:

1. See *T.C.A. Section 35-15-101-et seq.*
2. See *T.C.A. Section 35-15-501 et seq.*
3. See *T.C.A. 35-15-816(27).*
4. See *2013 Restated Comments to Official Text for T.C.A. Section 35-15-101 et seq.*
5. See *2013 Restated Comments to Official Text for T.C.A. Section 35-15-101 et seq.*
6. See *T.C.A. Section 35-15-111.*
7. See *T.C.A. Section 35-15-417.*
8. See *T.C.A. Section 35-17-101 et seq.*
9. See *T.C.A. Section 35-15-510.*
10. See *T.C.A. Section 67-2-110(b).*