V. TRUSTS AND ALIMONY

The purpose of this section is to give a general overview of trusts so that one can understand the basic terminology and mechanics of a trust, the different types of trusts that can be established, which types of trusts can protect against creditors, and how such protection may be limited in the instance of divorce. Since there are many complexities with the creation of trusts, this section is not intended as a guide to actually form and fund a trust.

A. BASIC TERMINOLOGY AND MECHANICS

1. WHAT IS A TRUST AND HOW IS ONE CREATED?

Trusts have been variously defined as: "an equitable right, title, or interest in property, real or personal, distinct from the legal ownership thereof" (2 Story, Eq. Jur. § 964); or as a "confidence reposed in some other, not issuing out of the land, but, as a thing collateral to and next in privity to the estate of the land and to the person, touching the land, for which the cestui que trust has no remedy but by subpoena in chancery" (Perry and Lewin on Trusts); or as "an equitable obligation, either expressed or implied, resting upon a person by reason of confidence reposed in him, to apply or deal with property for the benefit of some other person, for the benefit of himself and others, according to such confidence" (see Perry, Trusts, § 2); or, it is said, "a trust exists where the legal interest is in one person, and the equitable interest is in another;" "a trust is where property is conferred upon and accepted by one person, on terms of holding, using, or disposing of it for the benefit of another;" "a confidence reposed in a person that he will act in certain manners for the benefit of another; but, technically, it signifies a holding of property subject to a duty of employing it or applying its proceeds according to directions given by the person from whom it was derived" (see 27 Am. & Eng. Enc. Law, pp. 3, 4). Muldoon v. Trewhitt, 38 S.W. 109, 112 (Tenn. Ct. Ch. App. 1896).

Essentially, a trust is an arrangement between an agent, known as a trustee, property, known as corpus, and beneficiaries. The trustee manages and holds the property for the benefit of beneficiaries, in accordance with the trust document. The person who contributes the property to the trust is known as a grantor or trustor or settlor or trustmaker (these four words all mean exactly the same thing, and it's a matter of style preference as to which one an estate planner uses). For ease of understanding, this section will use the term "grantor," throughout, although any of the four terms are equally correct. Also note that there can be more than one grantor of a trust.

A trust may be created by: (1) the transfer of property to another person as trustee during the grantor's lifetime or by will or other disposition taking effect upon the grantor's death; (2) the declaration by the owner of property that the owner holds identifiable property as trustee (aka self-declaration); (3) the exercise of a power of appointment in favor of a trustee; or (4) a court pursuant to its statutory or equitable powers in accord with Tennessee Code Annotated § 35-15-102. Tenn. Code Ann. § 35-15-401 (Lexis Advance through the 2016 Regular Session and the 2nd Extraordinary Session of the 109th Tennessee General Assembly). The terms of a trust are the manifestation of the grantor's intent regarding a trust's provisions as expressed in the trust instrument or as may be established by other evidence that would be admissible in a judicial proceeding. Tenn. Code Ann. § 35-15-103(33). A trust instrument is an instrument executed by the grantor that contains terms of the trust, including any amendments thereto. Tenn. Code Ann. § 35-15-103(36). We generally will be discussing trusts intentionally set up by an estate planner, by the grantor via forms obtained online, through a form book, etc.

Practice Tip: As the trustee is the one to actually hold the trust property on behalf of the trust, property must be conveyed to the trustee on behalf of the trust. What does this mean as a practical matter? It would be improper to deed property directly to a trust, i.e. Sally Smith hereby conveys to The John Smith Revocable Trust all of her interest in Blackacre (this would be incorrect). Instead, it would have to be Sally Smith hereby conveys to the Trustee of the John Smith Revocable Trust all of her interest in Blackacre.

Caution: Improperly conveyed property might be uninsurable for title insurance purposes until corrected. It can be very difficult to correct improperly conveyed property once a person has passed away or is incompetent.

2. TRUSTEE DUTIES AND RESPONSIBILITIES

A trustee is a fiduciary and, as such, has fiduciary duties to properly maintain the trust in accordance with the Tennessee code. A trustee can be an individual, a company, or a professional, and there can be co-trustee(s). See Tenn. Code Ann. § 35-15-103, cmt. As everyone learns in law school, it is well settled that a trust will not fail for want of a trustee. Pinson v. Ivey, 9 Tenn. 296, 332 (1830). As such, if a trust document fails to name a trustee, or there are no named trustees able or willing to serve, then there either can be a mechanism within the trust to name a trustee, or a court can name a trustee. Tenn. Code Ann. § 35-15-704.

Part 8 of the Tennessee Uniform Trust Code sets forth the fundamental duties and responsibilities of a trustee. See Tenn. Code Ann. § 35-15-801, *et seq*. The primary duty of a trustee is to follow the terms and purposes of the trust and to do so in good faith. Tenn. Code Ann. § 35-15-801, cmt. A trustee owes a duty of loyalty to the beneficiaries of the trust and shall administer the trust solely in the interests of the beneficiaries. Tenn. Code Ann. § 35-15-802. The trustee shall not place its own interests over those of the beneficiaries. Id. A trustee also owes a duty of impartiality so that if a trust has two (2) or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests. Tenn. Code Ann. § 35-15-803. Furthermore, a trustee has a duty to administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances of the trust. Tenn. Code Ann. § 35-15-804. In satisfying the "prudent person" standard, the trustee shall exercise reasonable care, skill, and caution. Id. In administering a trust, the trustee may only incur costs that are reasonable in relation to the trust property, the purposes of the trust, and the skills of the trustee. Tenn. Code Ann. § 35-15-805. If a trustee has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, the trustee shall use those special skills or expertise. Tenn. Code Ann. § 35-15-807. A trustee may delegate duties and powers that a prudent trustee of comparable skill could properly delegate under the circumstances. Tenn. Code Ann. § 35-15-807. A trustee shall take reasonable steps to take control of and protect trust property. Tenn. Code Ann. § 35-15-809. A trustee shall take reasonable steps to enforce claims of the trust and to defend claims against the trust. Tenn. Code Ann. § 35-15-811. A trustee shall keep trust property separate from the trustee's own property. Tenn. Code Ann. § 35-15-801(b). A trustee shall keep adequate records of the administration of the trust and shall keep the beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests. Tenn. Code Ann §35-15801(a); § 35-15-813(a).

3. TRUSTEE'S DECANTING POWER

Tennessee's decanting statute allows a trustee to use their discretionary powers to distribute the trust assets to a new trust. See Tenn. Code Ann. § 35-15-816(b)(27). Pursuant to the Tennessee Uniform Trust Code, a trustee's decanting power is considered a limited power of appointment that may be exercised with respect to any trust that is administered in Tennessee. Id.

cmt. In order to exercise its decanting power, the trustee is required to sign a written notarized instrument that is maintained with the records of the original trust as well as the second, new trust. Id. The trustee does not have to obtain consent of the beneficiaries or a court in order to exercise its decanting power. Id. The only limitation on a trustee's decanting power is that the power may only be exercised in favor of the proper objects of the exercise of the discretionary power. Id. This means that new beneficiaries cannot be added to the second trust, though the second trust does not have to benefit all of the beneficiaries of the original trust. Id.

4. VIRTUAL REPRESENTATION

Part 2 of the Tennessee Uniform Trust Code deals with the representation of beneficiaries and other interested persons, both by fiduciaries (such as a personal representative, guardian, or conservator) and through what is known as virtual representation. Virtual representation is when a parent can represent the interests of a child without the need for a court appointed guardian ad litem. The only requirement for virtual representation in Tennessee is that there be no material conflict of interest between the virtual representative and the person(s) represented. Tenn. Code Ann. § 35-15-101.

5. SPENDTHRIFT PROVISIONS

A spendthrift provision in a trust is a provision that withholds distributions from beneficiaries if there are creditors of the beneficiary attempting to attach the interest of the beneficiary. See Tenn. Code Ann. § 35-15-103(3); § 35-15-501. Under the Tennessee Uniform Trust Code, a spendthrift provision is valid only if it restrains both voluntary and involuntary transfers of a beneficiary's interest. Tenn. Code Ann. § 35-15-502. If a trust contains a valid spendthrift provision, a creditor is prohibited from attaching a protected interest and may only attempt to collect directly from the beneficiary after payment is made. Id. cmt. Once distributed to the beneficiary, any income paid from a valid spendthrift trust becomes subject to execution by creditors of the beneficiary. Id.

However, if the spendthrift provision is invalid, then a creditor may reach the beneficiary's interest before the beneficiary comes into possession of it. Id.; See also Atkins v. Marks, 288 S.W.3d 356 (Tenn. Ct. App. 2008). For example, if the grantor is also a beneficiary (which is called a "self-settled trust") then a spendthrift provision would be invalid, and the assets would be available to creditors of the grantor. There is one exception to this rule against self-settled spendthrift trusts in Tennessee, and that is the Tennessee Investment Services Act trust (and perhaps asset protection trusts from other states as well, see the Asset Protection Trust section infra).

The spendthrift clause would be effective (if properly set up) against the creditors of a beneficiary, even in divorce. For example, in Doksansky v. Norwest Bank Nebraska, N.A., the former spouse of a spendthrift trust beneficiary attempted to bring a claim for past due support against the debtor's interest in the trust that had been set up by the debtor's father. 260 Neb. 100, 615 N.W.2d 104 (2000). The court held that, because the debtor could not require the trustees to make distributions to satisfy his debt, his interest could not be reached by his former spouse. Id. Moreover, Pennsylvania caselaw is well settled that an interest in a spendthrift trust may not be attached by a former spouse to satisfy and equitable division debt. Clark v. Clark, 411 Pa. 251, 191 A.2d 417 (1963).

However, it is particularly unlikely to be effective in Tennessee in divorce in regards to the grantor, except under limited circumstances with Tennessee Investment Services Act trusts (see that section, infra). For example, in the Tennessee case of Barnett v. Barnett, the court determined that the self-settled spendthrift trust created by the husband was ineffective to insulate the property from the marital claims of the wife upon their divorce. 2010 WL 680983, 2010 Tenn. App. LEXIS 170, 18 (Tenn. Ct. App. Feb. 26, 2010). Mr. Barnett during the divorce changed his Wife as Trustee to his niece as Trustee. However, in Shenouda v. Shenouda, No. 03A01-9505-CV-00151,1995 WL 684858, 1995 Tenn. App. LEXIS 748 (Tenn. Ct. App. Nov. 20, 1995), the court approved Husband's creation of a trust using marital assets for the benefit of the children's education.

6. TRUST DISTRIBUTIONS

Distribution interests are generally classified as either a mandatory interest, a support interest, or a discretionary interest. Tenn. Code Ann. § 35-15-103(10)(C). A trust will typically have either outright distributions to a beneficiary (mandatory interest) or could hold back the money, and only allow distributions for what are known as "ascertainable standards" (support interest). The typical ascertainable standard is health, maintenance, education and support. See Tenn. Code Ann. § 35-15-103(3). For example, in the case of Brown v. Brown, the trust document provided that the trustee "may distribute to or for the benefit of the surviving Trustmaker and our descendants as much of the principal of the Family Trust as our Trustee, in its sole and absolute discretion, shall consider necessary or advisable for their education, health, maintenance, and support." 2013 WL 1619687, 2013 Tenn. App. LEXIS 255, 27-28 (Tenn. Ct. App. Apr. 16, 2013). The "surviving Trustmaker and descendants" were not mandatory beneficiaries of either the income or the principal of the Family Trust, but they still had a present interest in the Trust as discretionary beneficiaries. Id. The general rule applying to discretionary interests (i.e. distributions made at the discretion of the Trustee) is that, if trustees exercise discretionary powers conferred on them in good faith and without fraud or collusion, courts of equity will not undertake to control their discretion. Falls v. Carruthers, 20 Tenn. App. 681, 693 (1936); see also Tenn. Code Ann. § 35-15-814(b)(2) (permitting courts to review a trustee's discretion in distribution "only if the trustee acts dishonestly, acts with an improper motive, or fails to act if under a duty to do so"). Unlike a mandatory or support interest, a discretionary interest does not constitute an enforceable right or a property interest but "a mere expectancy." Tenn. Code Ann. § 35-15-814(b)(1).

So long as the distributions are made in accordance with these standards, then a spendthrift clause would remain effective. Note that a spendthrift clause might not be effective as to a beneficiary if there is set forth in the trust document an outright distribution to that beneficiary, as opposed to discretionary distributions or those made in accordance with ascertainable standards. See generally Tenn. Code Ann. § 35-15-502(a). But holdback provisions are permitted to allow the trustee to hold back an outright distribution in certain circumstances. For example, a trust may also hold back distributions in the case of a minor child, or before a beneficiary reaches a certain age. See generally Bennett v. Nashville Trust Co., 153 S.W. 840 (Tenn. 1912). The trust assets would generally be unavailable to a creditor of the beneficiary under those circumstances until distributed (or until the beneficiary has an unrestricted right to the assets). See Tenn. Code Ann. § 35-15-504(b); Atkins v. Marks, 288 S.W.3d 356, 371 (Tenn. Ct. App. 2008) ("Once distributed to the beneficiary, income paid from a valid spendthrift trust becomes subject to execution by creditors of the beneficiary; however, where the spendthrift provision as to income is invalid, a creditor may reach the beneficiary's interest in the income before the beneficiary comes into possession of it."). Notably under a spendthrift provision, the trustee is permitted to directly pay any expense of the beneficiary, regardless of the existence of an outstanding creditor, up to and including the point of exhausting the principal. Tenn. Code Ann. § 35-15-502(e). This remains true whether the beneficiary's interest is mandatory, support, discretionary or a remainder. Id. The provisions would utilize the spendthrift and discretionary distribution statutes and case law cited herein and in the previous section.

Distribution interests are considered separate rather than marital property for the purposes of achieving an equitable division of marital property, and therefore, distribution interests are not relevant to such division. See Tenn. Code Ann. § 35-15-103, cmt; see also Eldridge v. Eldridge, 137 S.W.3d 1, 18–19 (Tenn. Ct. App 2002) (affirming the trial court's refusal to classify part of the trust as marital property because the beneficiary lacked a present possessory interest in the trust). Indeed, the mere fact that one's spouse had provided services for the trust in a fiduciary capacity does not change nature of these interests, nor does the provision of such services create a marital property interest. Tenn. Code Ann. § 35-15-103, cmt. Therefore, it can be affirmatively stated that neither the furnishing of such services nor the results from or effects of such furnishing of services are pertinent to the equitable division of property. Id. While not subject to division themselves, the distributions can, however, ultimately have an effect as trust incomes are considered for purposes of alimony and child support. See Rogin v. Rogin, 2013 Tenn. App. LEXIS 448, at *18 (Tenn. Ct. App. July 10, 2013) (citing Tenn. Comp. R. & Regs. § 1240-2-4-.04(3)(a)).

B. TYPES OF TRUSTS

There are many different types of trusts, from revocable living trusts, to irrevocable life insurance trusts, and many more varieties, many of which we will cover briefly herein. However, these trusts can be generally broken down into two categories: revocable and irrevocable.

1. REVOCABLE TRUSTS

A revocable trust is a trust that the grantor reserves the right to change later. Tenn. Code Ann. § 35-15-103(28). These trusts are generally used to avoid probate. Since a revocable trust is revocable, it does not provide any asset protection whatsoever during the life of the grantor, nor is it immune from the creditors of the grantor's estate, except when certain retirement accounts or life insurance policies name the trust as a beneficiary, but only to the extent of those assets. Tenn. Code Ann. § 35-50-102; § 35-50-108. A revocable trust will not allow a grantor to shelter assets from Medicaid, nor from any taxes. See Bell ex rel. Bell v. Tenn. Dep't Human Servs., 2006 WL 74143, 2006 Tenn. App. LEXIS 25 (Ten. Ct. App. Jan. 12, 2006). In fact, for tax purposes a revocable trust is ignored (except for certain state purposes it might not be ignored if used for business purposes, and under certain circumstances a trust can be subject to Tennessee or other state level taxation). See generally C. Douglas Miller & R. Alan Rainey, Article, Dying with the "Living" (or "Revocable") Trust: Federal Tax Consequences of Testamentary Dispositions Compared, 37 Vand. L. Rev. 811, 814–17 (1984).

A revocable trust, revocable living trust, living trust, are all the same type of trust, and the different names are style choices. There is no required naming convention for trusts; therefore, the item to look for in the trust document is any abilities of the grantor to change the terms of the trust, particularly the abilities to revoke the trust, to change the beneficiaries of the trust, to direct the distribution of trust property, etc. See Revocable Trust, Black's Law Dictionary (10th ed. 2014).

A Revocable Living Trust is generally done for the purposes of avoiding having to go to probate court, not only in Tennessee but also in other states. See, e.g., Head v. Wachovia Bank of Ga., N.A., 88 S.W.3d 180, 187 (Tenn. Ct. App. 2002). This trust would only avoid probate, however, for items placed into the trust, either by deed, bill of sale, or other conveyance. This trust would likely not be able to avoid, for example, probate for real property in other countries, and a competent attorney in the relevant country should be consulted regarding the use of United States Trusts. That aside, United State trusts are generally poor vehicles for foreign assets, for reasons that exceed the scope of this section, but include difficulties with foreign jurisdictions recognizing properly United States trusts.

As stated previously, a Revocable Living Trust does not avoid taxes, Medicaid, and it does not protect against the creditors of the grantor. Remember, however, if the trust receives (after the death of the settlor) life insurance proceeds or retirement account proceeds those should still be protected from creditors. Tenn. Code Ann. § 35-50-102; § 35-50-108. Claims arise from a divorce, however, because the retirement account could have accrued during the marriage or the premiums for the life insurance policy might have been paid out of marital funds. See Gorbet v. Gorbet, 2012 WL 4847090, 2012 Tenn. App. LEXIS 714, at *36 (Tenn. Ct. App. Oct. 11, 2012) (noting that where a "whole-life policy was acquired during the marriage with marital funds" the trial court properly "classif[ied] the term-life policy as marital property"); Catignani v. Catignani, 1999 WL 976564, 1999 Tenn. App. LEXIS 734 at *17 (Tenn. Ct. App. Oct. 28, 1999) ("An interest in a retirement benefit plan is marital property subject to division . . . ."). Therefore, anything placed into a revocable trust (aside from life insurance and retirement proceeds) should therefore be available in divorce, subject to the same considerations as other assets regarding separate property issues. C.f. Dalton v. Dalton, 2006 WL 3804415, 2006 Tenn. App. LEXIS 819, at *16 n.8 (Tenn. Ct. App. Dec. 28, 2006).

As stated above, this trust will become irrevocable on the death of the grantor(s), unless it distributes to another revocable trust. As such, with a valid spendthrift clause, this trust may be able to protect against the creditors of the non-grantor beneficiaries, even in the case of divorce with those beneficiaries. As an example, if Johnny Mae contributes property to a revocable trust, upon his death the trust will become irrevocable, since he will no longer be alive to revoke it. If Sally Mae is the beneficiary, and there is a valid spendthrift clause, ascertainable standards and/or trustee discretion, and no current right for Sally Mae to demand distribution, then the undistributed amounts in the trust would be protected from Sally Mae's creditors.

Practice tip: Revocable Trusts, like all trusts, only control the assets transferred into them. As an example, let's say that a deed to Blackacre is in the name of Sally Smith, with no right of survivorship or tenancy by the entirety. Sally Smith has a revocable trust which states that Blackacre is to go to Johnny Mae. Sally Smith also has a valid Will that states Blackacre is to go to Mark Lee. Upon Sally Smith's death, once the Will is admitted to probate and goes through the proper procedures and Executor's deed, the property will go to Mark Lee. It won't go to Johnny Mae since it was not transferred into the trust (unless her Will had been a pour over will and named her trust as a beneficiary). A pour over will is a type of will whereby the residuary beneficiary is a trust or trusts. Therefore, the purpose is to pour over property into the trust that was not already transferred to the trust. Most estate planning practitioners can attest to the fact that many, if not most, revocable trusts end up being empty due to a failure to convey assets to the trust.

Additional practice tip: Had the deed stated instead Sally Smith and Gary Smith, as either a married couple or joint with survivorship, then the interest would have gone to Gary Smith, and would not go to Johnny or Mark.

2. IRREVOCABLE TRUSTS

An irrevocable trust generally cannot be revoked by the grantor (although there may be decanting allowed under certain circumstances as described infra). As such, a grantor would give up grantor's right to make changes to the trust. So long as the grantor is not also a beneficiary (except for asset protection trusts as discussed infra), and so long as any fraudulent transfer or bankruptcy laws aren't violated, then the trust assets would not be reachable by the creditor of the grantor. 11 U.S.C § 548(e)(allows avoiding transfers within ten years of filing of petition if transfer to hinder, delay or defraud any entity); Tenn. Code Ann. § 66-3-301 (Tennessee's Uniform Fraudulent Transfer Act).

The most common irrevocable trust is the Irrevocable Life Insurance Trust, commonly known as an "ILIT". The purpose of this trust is to allow proceeds of a life insurance policy to avoid estate taxation. The basic way this trust typically works is that the grantor or grantors (in the case of a second to die policy) gift to the trust's bank account. The money is then held in that account for a certain period of time, and the beneficiary is given a "Crummey letter" which informs them that they have a certain amount of time to withdraw the money from the account. Note that the letter is called "Crummey" because it is from a famous case, <u>Crummey v. Commissioner</u>, 397 F.2d 82 (9th Cir. 1968), and not because it's crummy. If the beneficiary does not withdraw the money in that period of time, then the trust can use the money to pay the life insurance premium. The purpose of this setup is to use annual exclusion gifts to pay the premiums. Annual exclusion gifts are gifts below the reporting threshold, and as such do not reduce a person's gift and estate tax credit. Annual exclusion gifts are only allowed to be made to human beings, and not trusts, so the purpose of the Crummey letter is to tie the gift into a person (i.e. the Crummey letter recipient who can withdraw the money). There cannot be a pre-agreement not to withdraw the money, and there is a risk with this trust that the trust will not be able to make the payments if the beneficiary withdraws the money. The funds gifted to the bank account are in theory available to the creditors of the beneficiary before it lapses. Many practitioners currently use a Crummey waiver letter rather than having to do an annual Crummey letter.

When the grantor or grantors die, the proceeds then go to the ILIT. Since the premiums are treated as having been paid by the beneficiary, the proceeds are kept out of the grantor(s) estate(s) for estate tax purposes. Since the proceeds are going to the trust, the trust and neither the grantor nor the beneficiaries would own the proceeds. The proceeds would then be administered, distributed, invested, etc. in accordance with the terms of the ILIT document. Provided that the ILIT has proper spendthrift or holdback provisions, these proceeds would not be available to the creditors of the beneficiaries. Again, since the trust is irrevocable, the proceeds would also not be available to the creditors of the grantor's estate.

3. GRANTOR VERSUS NON-GRANTOR TRUSTS

For tax purposes, a trust can be either a grantor trust or a non-grantor trust. For a grantor trust, the grantor retains certain powers, and therefore the trust will still be subject to the income tax of the grantor. For a non-grantor trust, the grantor does not retain those powers, and as such either the trust itself or the beneficiaries will be taxed (the taxation of trusts will be discussed infra).

All revocable trusts are grantor trusts. All non-grantor trusts are irrevocable trusts. However, not all irrevocable trusts are non-grantor trusts. An irrevocable trust may still have certain retained powers by the grantor, such as the right of grantor to substitute property of equal value, that will make the trust a grantor trust for income tax purposes, even though the grantor cannot revoke the trust. This type of trust is known as an "intentionally defective grantor trust" since it is intentionally defective for income tax purposes. As such, the grantor would still be taxed on the income of the trust. For estate tax purposes, such a trust (if properly set up) would not be so defective, and therefore would be treated as not being owned by the grantor for estate tax purposes.

As the saying goes, nothing is certain but death and taxes. This is especially true with trusts. Eventually, the grantor or grantors will die. At that point, the trust will generally become irrevocable, and would be a non-grantor trust subject to its own taxation. At that point, the trust assets would either be distributed in accordance with the trust agreement, or they would continue to be held in the trust in accordance with the trust agreement.

4. CHARITABLE TRUSTS

Trusts can also be set up to gain tax advantages by utilizing charitable donations. A charitable trust is a trust, or portion of a trust, created for a charitable purpose as described in Tennessee Code Annotated § 35-15-405(a). Tenn. Code Ann. § 35-15-103(6). There are many different types of charitable trusts, including charitable remainder trusts and charitable lead trusts. Essentially, some of these trusts might give a lifetime income to a beneficiary, and the remainder to a charity or, in the reverse, give an income to a charity and the remainder to a beneficiary. The various income formulas that can be used exceed the scope of this section. Generally, it will have to be examined as to the specific interests a beneficiary has in such a trust in order to determine if it is attachable by a creditor.

C. TRUSTS THAT CAN PROTECT AGAINST CREDITORS

1. ESTATE TAX PLANNING TRUSTS

Under current tax law, married citizen spouses can gift an unlimited amount to each other tax free and with no reporting. Also under current tax law each person can give away (or die with) a little more than five million dollars (indexed for inflation) without any estate taxes. The purpose of a marital trust is to utilize this unlimited gift ability. Although the exact specifics of a marital trust can be complex, basically the spouse must at least receive the income from the trust annually. Therefore, in this type of trust there may be assets available to creditors of the beneficiary of the marital trust (i.e. the income interest and possibly a limited right to some corpus).

Credit shelter trusts were originally created to preserve the estate tax credit of one spouse, since that spouse's credit would be lost if all of their estate passed to their spouse under the marital deduction. The current estate tax law allows for portability of this credit, and therefore these types of trusts are used less than before. However, they can still be useful and are still used in planning. Credit shelter trusts typically name a couple's children as the beneficiary, although they can provide for the health, maintenance and support of a spouse during life, and can also have limited withdrawal powers of principal (5% or $5,000.00 per year). Therefore, there may also be assets available to a creditor of the surviving spouse, depending upon their withdrawal rights.

These marital and credit shelter trusts are often referred to as A/B trusts. They are typically funded in accordance with sometimes complex formulas. A spouse could become the beneficiary of any multiple of these trusts if they remarry and have more than one spouse pass away.

Caution: In the current political environment the future of the estate and gift tax is uncertain and its effect on trusts is unknown. However, basic planning, such as the use of revocable trusts and pour over wills, is unlikely to change.

2. ASSET PROTECTION TRUSTS

Tennessee and several other states have asset protection trust laws. These are self-settled spendthrift trusts created under the laws of those various states. Normally, a self-settled spendthrift trust would be prohibited, but if these specific statutes are followed then they can be created. However, there are typically exception creditors to these trusts, such as in the case of child support or alimony, and occasionally in the case of torts. Also, there are fraudulent transfer laws and bankruptcy laws that may circumvent these protections in these trusts. Tennessee's specific asset protection trust law, Tennessee Investment Services Act Trusts, will be covered in the next section on Tennessee specific trusts.

In addition to domestic asset protection trusts, there are also trusts created in foreign jurisdictions, aka Foreign Asset Protection Trusts ("FAPTs"). However, under many of the jurisdictions that solicit asset protection trust business, there are many restrictions on fraudulent transfer laws, a prohibition on contingency cases, and many other roadblocks. Typically, therefore, it is very difficult to reach the assets of those trusts going through the foreign jurisdiction. Therefore, more success has been had in finding the grantors, who typically are still in the United States, in contempt in order to encourage them to try to bring the assets back (but may actually not be possible due to anti-duress provisions in the trust). Such contempt orders have been routinely granted by courts, see, e.g., FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir. 1999); In re Lawrence, 279 F.3d 1294 (11th Cir. 2002).

If any of the trust assets are contained in the United States or other more friendly jurisdictions then there may be ways to reach those assets and in effect pierce the trust. When assets are located in a state that either does not have its own asset protection trust law or has different exception creditors, it is unlikely that a court in that state will recognize either the trust's protections or the exceptions.

A creditor could attack a self-settled asset protection trust by arguing that the law of a different jurisdiction applies. For example, if you create a Delaware asset protection trust, a creditor from New York may argue that New York law applies instead of Delaware law because the offense occurred in New York and the offended party is a resident of New York. Because the laws of the State of New York do not allow a debtor to protect assets in a self-settled trust, the New York courts could potentially allow a New York resident to obtain a judgment against the trust. Similarly, it is possible that a federal court (including a bankruptcy court) could refuse to recognize the laws of a jurisdiction that provides asset protection for a self-settled trust. There are federal bankruptcy cases where the bankruptcy court has refused to recognize the self-settled trust laws of a foreign jurisdiction because it is against the policy of the federal bankruptcy courts. See Marine Midland Bank v. Portnoy (In re Portnoy), 201 B.R. 685 (Bankr. S.D.N.Y. 1996); Sattin v. Brooks (In re Brooks), 217 B.R. 98 (Bankr. D. Conn. 1998). In the Portnoy case, Judge Brozman of the Federal Bankruptcy court said, "I think it probably goes without saying that it would offend our policies to permit a debtor to shield from creditors all of his assets because ownership is technically held in a self-settled trust." In re Portnoy at 700. Also, Section 548 of the Bankruptcy Code as well as the various fraudulent transfer laws (or voidable transaction laws) can also be used to pierce self-settled asset protection trusts (although some of the fraudulent transfer laws might be limited by the asset protection trust act in that state, if any. See the Tennessee Investment Service Trust section infra).

3. TENNESSEE INVESTMENT SERVICES TRUSTS

Investment Services Act trusts are Tennessee's version of what are colloquially known as domestic asset protection trusts. The Tennessee Investment Services Act of 2007 can be found at Tennessee Code Annotated § 35-16-101, *et seq*. As stated previously, the basic concept of all trusts is that there is a person who gives property (typically called a grantor or settlor) to a person (known as a trustee) to hold on behalf of the trust's beneficiaries. Historically, all of the states forbid self-settled spendthrift trusts. To review: "Self-settled" means the grantor (i.e. the person putting the assets into the trust) is also a beneficiary. "Spendthrift" is a provision whereby the trustee decides how the trust funds are spent for the beneficiary, and therefore creditors cannot reach the funds in the trust. See generally, Tenn. Code Ann. § 35-15-103, cmt. Generally, this means the beneficiaries do not have direct control over the trust. It should be noted however that a creditor of that beneficiary could reach any property distributed to that beneficiary.

Tennessee Code Annotated § 35-15-505 generally allows creditors of the grantor to reach assets transferred by a grantor to a trust of which he or she is also the beneficiary. However, the Tennessee Investment Services Act of 2007 established an exception to that rule by authorizing the creation of self-settled trusts that are exempt from the grantor's creditors if certain conditions are met. Tenn. Code Ann. § 35-16-101, cmt.

The main benefits of the Tennessee Investment Services Act trust (as amended effective July 1, 2013) are that pre-transfer creditors have either two years from the date of the transfer of the property to the trust (or six months from the date of the creditor's having discovered the transfer) to challenge the transfer or they are barred from bringing a claim. See Tenn. Code Ann. § 35-16-104. Also, a much longer ten year statute of limitations may also apply in certain cases of bankruptcy. See 11 U.S.C. § 548(e). An interesting aspect of Tennessee law is that "discovery" is deemed if the transfer is a public record. Tenn. Code Ann. § 35-16-104. Many attorneys have begun recording affidavits of transfers in the applicable counties in order to make the transfers a public record, and thus ensure the shortest statute of limitation possible. Even if an action is filed within the statute of limitations period, it must be shown with clear and convincing evidence that the transfer was for the purpose of defrauding that creditor. Id.

In order to be eligible as an Investment Services Trust, the trust agreement must be irrevocable, must appoint at least one qualified trustee, must incorporate Tennessee law to govern the validity, construction, and administration of the trust, and must contain a spendthrift provision prohibiting the grantor or any beneficiary from transferring, assigning, pledging, or mortgaging their interest in the trust. Tenn. Code Ann. § 36-16-102.

An investment services trust is an instrument that appoints a qualified trustee and:

(1) expressly incorporates Tennessee law to govern the validity, construction, and administration of the trust;

(2) is an irrevocable trust; and

(3) includes a spendthrift provision

See § Tenn. Code Ann. 35-16-102(7).

The qualified trustee must:

(1) be a Tennessee resident or a corporate trustee licensed under Tennessee law, and

(2) have at least some certain duties such as custody of assets, preparing tax returns, or be materially administering the trust, and

(3) cannot be the transferor/grantor

See Tenn. Code Ann. § 35-16-102(12).

In order to take advantage of the creditor protection provided by an Investment Services Trust, the grantor must make a qualified disposition to the trust. In order to be a qualified disposition, the grantor must execute a qualified affidavit prior to making a transfer to the trust. The purpose of the affidavit is to make sure that the grantor is not defrauding his or her creditors. The statute lists seven (7) specific statements that must be addressed/included in the affidavit:

(1) the grantor has full right, title, and authority to transfer the assets to the trust;

(2) the transfer of the assets to the trust will not render the grantor insolvent;

(3) the grantor does not intent to defraud a creditor by transferring the assets to the trust;

(4) the grantor does not have any pending or threatened court actions against the grantor, except for those court actions identified by the grantor on an attachment to the affidavit;

(5) the grantor is not involved in any administrative proceedings, except for those identified on an attachment to the affidavit;

(6) the grantor does not contemplate filing for relief under the federal bankruptcy code; and

(7) the assets being transferred to the trust were not derived from unlawful activities.

See Tenn. Code Ann. § 35-16-103. There is no time limit for making a transfer to the Investment Services Trust after the affidavit is executed. Nevertheless, no transfers should be made after any of the statements in the affidavit become inaccurate.

The Tennessee Investment Services Trust Act does not protect assets from all creditors. The Tennessee Act permits certain "exception creditors" to be exempted from the provisions protecting trust assets. In order for an "exception creditor" to reach assets in an Investment Services Trust, there must be a final court order that a debt is due, such as for child support, alimony, spousal support, or division of marital property. Tenn. Code Ann. § 35-16-104, cmt. The court must also determine that the claimant has made reasonable efforts to collect the debt or that such attempts would be futile. Id. The Tennessee Investment Services Trust Act does not protect against past due child support, past due alimony, and a written agreement, judgment or order of the court for division of marital property of a spouse or former spouse, but only to the extent of such debt, legally mandated and the reasonable cost of collection. Tenn. Code Ann. § 35-16-104(i). It is important to note that child support obligations and obligations stemming from alimony or spousal support are outside of this statute's protections against creditors. The statute allows a "spouse" or "former spouse" to become an "exception creditor" under certain circumstances. Tenn. Code Ann. § 35-16-102, cmt. The statute defines "spouse" or "former spouse" as a person to whom the grantor was married to at or before the time of the qualified distribution to the Investment Services Trust. Tenn. Code Ann. § 35-16-102(13). Funding an Investment Services Trust prior to getting married is an effective method of protecting assets in the event of a subsequent divorce. Tenn. Code Ann. § 35-16-102, cmt. Moreover, unlike some domestic asset protection trust statutes, tort claimants are not "exception creditors" in Tennessee (i.e. tort claimants would be treated the same as any other creditors for the purposes of the Tennessee act). Tenn. Code Ann. § 35-16-104, cmt.

Additionally, the limited case law has shown that domestic asset protection trusts may have limited or no protection for assets located outside of the state of domicile for the trust.

Nonresidents of Tennessee can certainly set up Tennessee Investment Services Act trusts, particularly if the qualified trustee and the property are located in Tennessee, but great care must be used if property outside of Tennessee is to be added to the trust. It is generally better to use the domestic asset protection trust law of the state of domicile (provided that said state has such a law) since a recent case out of Utah (regarding a Nevada asset protection trust) has shown that even among states with asset protection trust laws, other states' laws may create difficulties in enforcing the domestic asset protection trust. See Dahl v. Dahl, 2015 UT 23 (2015).

In the Dahl case, the Utah Supreme Court held that Mrs. Dahl had an enforceable interest in a Nevada asset protection trust that was established by her husband during the marriage with marital property. The trust instrument expressly stated that the trust was irrevocable and it provided that the trust was to be governed by Nevada law. However, the Utah Supreme Court held that Utah law applied since Utah has a strong public policy in favor of the equitable distribution of marital assets upon divorce and the application of Nevada law would deny the court the ability to equitably divide the marital assets. The court then determined that, under Utah law, the trust was revocable because Mr. Dahl, as grantor, had retained the power to amend the trust in any manner. Fortunately, Tennessee's Investment Services Act does have provisions allowing trusts from other states to be transferred to Tennessee. Tenn. Code Ann. § 35-16-106.

4. TENNESSEE COMMUNITY PROPERTY TRUSTS

Although Tennessee is not a community property state, it is possible through the use of a special type of trust, a community property trust, to elect community property treatment for assets put into the trust. A trust becomes a community property trust if one or both spouses transfer property to a trust that:

(1) expressly declares that the trust is a Tennessee community property trust;

(2) has at least one trustee who is a qualified trustee and whose powers include, or are limited to, maintaining records for the trust and preparing or arranging for the preparation of any income tax returns that must be filed by the trust (both spouses or either spouse may be a trustee);

(3) is signed by both spouses; and

(4) contains the following language in capital letters at the very beginning of the trust document: THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH YOUR SPOUSE

BOTH DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE.

Tenn. Code Ann. § 35-17-103.

One of the main reasons these trusts are set up is that there can be a double step in basis. Without community property, when one spouse dies there is only a half step-up in basis typically with property owned jointly. With community property, it is possible to receive a full step up on the death of one spouse for property owned jointly. See 26 U.S.C.S. § 1014(b)(6). As an example of how this would work: assume Sally Smith and Henry Smith bought a rental property for $100. At Sally Smith's death, the property has appreciated in value to $200. If the property is sold at that point for $200 there would be a 50% step up in basis, so there would be tax on $50 of gain ($100.00 basis plus $50 step up). If the property had instead been in a community property trust, there would be a full step up at Sally Smith's death and there would be no tax if the property sold for $200. There would be another full step up at the death of Henry Smith.

5. TENNESSEE TENANCY BY THE ENTIRETY TRUSTS

When a husband and wife own real property jointly, unless otherwise stated in the deed the property will receive Tenancy By The Entirety protection, meaning that a creditor of only one spouse cannot reach the interest until the other spouse dies. If the debtor spouse passes away first instead, then a creditor of only the debtor spouse would not be able to reach any of the interests in the property. A Tenancy By The Entirety Trust allows this treatment to be preserved with the use of a trust or trusts, provided that the statutory requirements are followed, including the required language to be listed on the deed.

Any property of a husband and wife that was held by them as tenants by the entirety and subsequently conveyed as tenants by the entirety to the trustee of one or more trusts, and the proceeds of that property, shall have the same immunity from the claims of their separate creditors as would exist if the husband and wife had continued to hold the property or its proceeds as tenants by the entirety, so long as:

(1) the husband and wife remain married;

(2) the property or its proceeds continues to be held in trust by the trustee or their successor in interest;

(3) the trust or trusts are, while both grantors are living, revocable by either grantor or both grantors, acting together;

(4) both the husband and wife are permissible current beneficiaries of the trust while living; and

(5) the trust instrument, deed, or other instrument of conveyance provides that this section shall apply to the property or its proceeds.

Tenn. Code Ann. § 35-15-510.

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