ASSET PROTECTION PLANNING:

VOLUNTEERING FOR TROUBLE?

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Bryan Howard
Holland & Knight LLP
511 Union Street, Suite 2700
Nashville, TN 37219
(615) 850-8111
bryan.howardmobley@hklaw.com

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I. Non-Trust Asset Protection.

A. 529 Plans – 529 Plans are exempt from attachment by creditors T.C.A. Section 49-7-822.

B. Life Insurance and Annuities

1. T.C.A. 56-7-201. Life insurance payable to surviving spouse and children. Effect of proceeds being payable to estate.

On the death of an insured, any life insurance acquired by the insured or the insured's spouse and payable to the intestate insured's estate benefits the surviving spouse and children and the proceeds shall be divided between them according to the statutes of distribution without being in any manner subject to the debts of the decedent. If the proceeds of the insurance are payable to the estate of a testate decedent or the trustee of a revocable trust of which the decedent was a settlor, the proceeds shall pass as part of the estate or trust and under the dispositive provisions of the will or trust agreement, as ordinary cash, whether or not the will or trust agreement uses any apt or express words referring to the insurance proceeds, but the proceeds shall not be subject to the debts of the decedent unless specifically charged with the debts in the will or trust agreement.

2. T.C.A. § 56-7-203. Life insurance or annuity for or assigned to spouse or children or dependent relatives exempt from claims of creditors.

The net amount payable under any policy of life insurance or under any annuity contract upon the life of any person made for the benefit of, or assigned to, the spouse and/or children, or dependent relatives of the persons, shall be exempt from all claims of the creditors of the person arising out of or based upon any obligation created after January 1, 1932, whether or not the right to change the named beneficiary is reserved by or permitted to that person.

C. Limited Liability Companies

1. Inside Liability Protection

A member, holder of financial interest, governor, manager, employee or other agent of an LLC does not have any personal obligation and is not otherwise personally liable for the acts, debts, liabilities, or obligations of the LLC whether such arise in contract, tort or otherwise. T.C.A. § 48-217-101.

2. Outside Liability Protection

A Creditor can obtain a charging order that requires the LLC to turn over to the creditor any distributions to be made to the member. The creditor cannot reach the LLC's assets or force a sale of the member's membership interest. T.C.A. § 48-218-105 and 48-249-509.

3. There are similar rules for limited partnerships. T.C.A. § 61-3-703.

D. Retirement benefits – IRAs

26-2-105. State pension moneys, certain retirement plan funds or assets, exempt — Claims under qualified domestic relations order.

> (b) Except as provided in subsection (c), any funds or other assets payable to a participant or beneficiary from, or any interest of any participant or beneficiary in, a retirement plan which is qualified under §§ 401(a), 403(a), 403(b), 408 and 408A, or an Archer medical savings account qualified under § 220 or a health savings account qualified under § 223 of the Internal Revenue Code of 1986, as amended, are exempt from any and all claims of creditors of the participant or beneficiary, except the state. All records of the debtor concerning such plan and of the plan concerning the debtor's participation in the plan, or interest in the plan, are exempt from the subpoena process.

E. Tenancy by the Entirety - Under Tennessee law, a married couple can own property (both real and personal property) as tenants by the entirety. See Bryant v. Bryant, 522 S.W.3d 392, 400 (Tenn. 2017) (citing Griffin v. Prince, 632 S.W.2d 532, 534-35 (Tenn. 1982). An individual spouse's creditor cannot seize that individual's interest (and then force the sale of the property). Only a joint creditor of both spouses may enforce a lien against the property.

II. Creditor Protection from Trusts

A. Third-Party Created Trusts

1. Virtually all trusts created for others are established as "spendthrift trusts" and enjoy protection from creditors pursuant to T.C.A. § 35-15-502.

2. Types of trusts include inheritance trusts and gift trusts.

3. Creditors cannot force the Trustee to make distributions.

4. After a distribution is made, the creditor can attempt to collect from the Beneficiary.

5. The Trustee can make direct payments to others for the benefit of the beneficiary. T.C.A. §§ 35-15-504 and 506.

6. When a spendthrift trust acquires a "dangerous" asset, consider dividing the trust (T.C.A. § 35-15-417) or decanting the dangerous asset to a new trust (T.C.A. § 35-15-816(c)).

B. Self-Settled Trusts

1. The general rule is that a creditor can reach the maximum amount that can be distributed to the settlor. T.C.A. § 35-15-505(a)(2).

2. There are specific exceptions to the general rule for Tennessee Investment Services Trusts, Tenancy by the Entirety Trusts, Special Needs Trusts, and Inter-Vivos QTIP Trusts.

E. Tennessee Investment Services Trusts (Asset Protection Trusts) T.C.A. § 35-16-101, et seq.

1. Requirements

   a. The trust instrument must:

      i. be irrevocable,

      ii. state that Tennessee state law governs validity, construction, and administration of the trust,

      iii. contain a spendthrift clause, and

      iv. have at least one qualified trustee. A qualified trustee is a Tennessee resident (not the trustor) or a

Tennessee bank or trust company which performs specified actions.

b. As of January 1, 2022, the settlor is no longer required to sign an affidavit to establish a self-settled asset protection trust or to make transfers to the trust.

2. The settlor of a Tennessee self-settled asset protection trust is allowed to retain the following rights:

   a. the power to veto a distribution from the trust;

   b. testamentary limited power to appoint the trust assets;

   c. the right to receive income from the trust;

   d. the right to direct the investments of the trust;

   e. the right to receive principal payments at the discretion of the trustee or other advisor;

   f. the right to remove and replace the trustee or other advisor;

   g. live in a home owned by the trust; and

   h. withdraw up to 5% of the trust principal annually.

3. Tax Consequences

   a. Income Tax

      i. Trust will usually be a grantor trust

      ii. Grantor trusts are disregarded for federal income tax purposes

      iii. Non-grantor trusts may save income taxes for residents of certain other states

   b. Gift & Estate Tax

      i. Transfer will usually be structured as an incomplete gift

      ii. Incomplete gifts are not subject to gift tax, but will be taxable for estate tax purposes upon death

iii. PLR 200944002 - Self-settled asset protection trust not included in Settlor's estate

4. Uses of Tennessee Investment Services Trusts

a. Asset Protection for certain assets

b. Part of estate plan for client with certain amount of wealth

c. Gifting trust for a client that wants certain assurances

d. Out of state residents – state income tax reduction

e. Alternative to prenuptial agreement

F. Tenancy by the Entirety Trusts

1. A tenancy by the entirety trust ("TBET") is a trust for a married couple that provides the same protection for state law purposes from the claims of the separate creditors of the husband and wife as would exist if the husband and wife owned the trust assets directly as tenants by the entirety

2. Being able to transfer tenants by the entirety property to a TBET without sacrificing creditor protection will make it more feasible for couples to use revocable trusts for their various benefits, including incapacity management, probate avoidance, and privacy.

3. A tenancy by the entirety may be created in personal property as well as real property in Tennessee

4. Requirements:

a. Property must be held as tenants by the entirety prior to the conveyance to the trust.

b. Such persons must remain married

c. Property must continue to be held in trust

d. While both spouses are living, the trust must be revocable by either spouse or by both of them acting together

e. Both spouses must be beneficiaries of the trust

f. Trust instrument, deed, or other instrument of conveyance must specify that the new statute apply to the property

5. After First Spouse's Death

a. After the death of the first spouse, property will continue to be exempt from the claims of the decedent's separate creditors

b. If the survivor can withdraw trust assets, the property will not be protected from the survivor's creditors

c. In contrast, traditional tenants by the entirety property passes to the survivor automatically upon the death of the first spouse

d. A TBET is more flexible

i. For example, the TBET could convert to an irrevocable trust for the benefit of the survivor, with the remainder to pass to children after the survivor's death

ii. Provides better asset protection for the surviving spouse as well as for the children who are remaindermen beneficiaries, e.g. if the survivor remarries.

G. Inter Vivos QTIP Trusts

1. Exempt from donee spouse's creditors because it was created by 3rd party.

2. Donor spouse can retain mandatory income interest and discretionary principal interest after donee spouse's death - Tennessee law says trust is protected from donor spouse's creditors. T.C.A. § 35-15-505(d). Federal estate tax law says that donor spouse will not have estate tax inclusion. See Treasury Regulation 2523(f)-1(f), Example 11.

H. Foreign Asset Protection Trusts – Tennessee gives no exemption from the general rule that self-settled trusts are subject to creditors. Any protection provided by such trusts is based on the law of the jurisdiction in which the trust is established.