PUBLICATION

Protecting Your Nest Egg: Use of the Asset Protection Trust in Tennessee

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Historically, trusts have been among the most regularly used and accepted asset protection tools when an individual sought to make assets available to beneficiaries but wished to protect those assets from creditors. Until the late 1990s, attention in this area was focused on the use of offshore trusts to protect assets, which were generally governed by more liberal laws and which often put assets out of reach of judgment creditors since many foreign jurisdictions do not recognize U.S. judgments. In 1997, however, both Alaska and Delaware enacted legislation permitting domestic asset protection trusts. Several other states quickly followed suit. In May 2007, Tennessee joined a handful of states in enacting its own legislation permitting the creation of self-settled asset protection trusts, with the enactment of the Tennessee Investment Services Act of 2007.

Prior to the enactment of the May 2007 legislation, if an individual created a trust under which he was the beneficiary, the assets of the trust were subject to the claims of creditors. As a result, an individual who built up a large nest egg could not retain control of those assets and ensure availability for future use while simultaneously shielding them from claims of creditors or judgment claims in the event of an accident, lawsuit or divorce. This changed with the enactment of the Tennessee Investment Services Act of 2007 (the Act).

Signed into law on May 10, 2007, the Act became effective July 1 of that same year. The Act was supported by the Tennessee Bankers Association and attempted to provide protection from creditors by allowing the creation of selfsettled, asset protection trusts referred to as "Investment Services Trusts." The Act has been beneficial to Tennessee banks and trust companies in that it allows Tennessee residents to keep assets in Tennessee rather than transferring them to other jurisdictions with more favorable trust laws. It also has allowed Tennessee financial institutions to administer trusts for residents located in neighboring states.

Briefly, the Act provides protection from creditors by allowing the creation of a self-settled, asset protection trust (or "IST"). An IST is a trust that appoints a qualified trustee to hold and administer property that is the subject of a qualified disposition. The IST must expressly incorporate the laws of the State of Tennessee to govern the construction, validity and administration of the trust; must be irrevocable; and must provide that the interest of the transferor or beneficiary of the trust property or income may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily, before distribution by the trustee.

With an IST, the individual creating the trust may retain the right to direct the investment of trust assets, to receive trust income, to request up to 5% of the trust principal annually, to receive additional distributions based upon the discretion of the trustee, to live in a home owned by the trust, to direct disposition of trust assets on death, and to remove the trustee and appoint a successor trustee who is not related to the individual creating the trust.

A "qualified disposition" is a transfer into the trust, with or without consideration for the transfer. In making a disposition, the transferor must sign a "qualified affidavit" which states that the transferor:

1. Has full right, title and authority to transfer the assets to the trust;
2. Will not be rendered insolvent by the transfer;
3. Does not intend to defraud a creditor by transferring the assets to the trust;

4. Does not have any pending or threatened court actions against him or her, except for those identified in an attachment to the qualified affidavit;
5. Is not involved in any administrative proceedings, except for those identified in an attachment to the qualified affidavit;
6. Does not contemplate the filing for relief under the federal bankruptcy code; and
7. Did not obtain the assets being transferred through unlawful activities.

In most instances, a qualified disposition cannot be attached by creditors unless the creditor makes a claim under the Uniform Fraudulent Conveyance Act. Creditors cannot make claims against a trustee or any person involved in the counseling, drafting, preparation, execution and funding of the IST.

The trustee of an IST must be either a Tennessee resident or an individual or entity authorized by Tennessee law to be a trustee and whose activities are subject to the control and supervision of the Tennessee Department of Financial Institutions, the FDIC, the Comptroller, or the Office of Thrift Supervision. The trustee must maintain and arrange for custody and control of property held under the IST, maintain the IST records, file the IST tax returns, or otherwise participate in the administration of the IST.

While the IST is useful in shielding a nest egg from claims of creditors, it is not without limitation. The IST does not provide asset protection for assets transferred to it until four years after the transfer. Additionally, federal bankruptcy law has a ten year period to set aside transfers which could apply to an IST under certain circumstances. Also, mandatory distributions and discretionary distributions, once made, may be attached by creditors. Finally, the law is unsettled as to whether a court in another state is required to recognize the creditor protection offered by an IST under the Full Faith and Credit clause of the U.S. Constitution.

In summary, Tennessee now offers enhanced asset protection through the use of the IST. Individuals concerned about creditor claims and lawsuits may now protect their nest eggs by using an IST, which can be accomplished without the complexity and uncertainty that accompany the offshore trust. While the IST is a useful asset protection tool, it is not without limitation. Individuals interested in the asset protection offered by an IST should proceed with caution and only with the direction of a qualified attorney. However, if properly drafted and funded, an IST offers a solution for protecting a nest egg while still retaining the ability to control the assets held under the trust.