

3 Developments Enhance Tennessee's Drive to Be a Top Trust Situs

In the last two decades, Tennessee trust laws have changed dramatically.[1] Some changes were intended to give Tennessee residents greater flexibility, while others were designed to attract money from out-of-state grantors.[2] As a result, Tennessee is often ranked among the top states for trust laws.[3]

By soon becoming one of only nine states (and the only state in the southeast besides Florida) not to tax trusts, Tennessee may even more likely become a haven for trusts created by out-of-state grantors.

Three recent developments enhance Tennessee's reputation, both for Tennessee residents and for nonresidents considering creating a trust situs in Tennessee.

Kaestner and State Income Tax

In a unanimous opinion issued on June 21, 2019, the U.S. Supreme Court in *Kaestner*[4] held that the State of North Carolina violated the Due Process Clause of the Fourteenth Amendment by taxing the accumulated income in a trust where the only connection to North Carolina was the primary beneficiary's residence in that state.

The *Kaestner* trust was created by a New York resident, under New York law, with a New York trustee, with trust records in New York. The successor trustee was a Connecticut resident, and the custodian of assets was in Massachusetts. The only connection to North Carolina was that the primary beneficiary had moved there after the trust was executed. The trustee had total discretion over the timing and amount of any distributions and had made no distributions to the beneficiary in the years in question, accumulating all the income in the trust. The North Carolina Department of Revenue assessed tax of over $1.3 million on such income. The trustee paid the tax under protest and filed in state court for a refund. The trial court, court of appeals, and state supreme court all found that the taxation violated the Due Process Clause.

The Supreme Court affirmed, holding that there must be "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax."[5] The court recognized that each component of a trust relationship needed to be evaluated separately. "In sum, when assessing a state tax remised on the in-state residency of a constituent of a trust — whether beneficiary, settlor, or trustee — the Due Process Clause demands attention to the particular relationship between the resident and the trust assets that the State seeks to tax. Because each individual fulfills different functions in the creation and continuation of the trust, the specific features of that relationship sufficient to sustain a tax may vary depending on whether the resident is a settlor, beneficiary, or trustee."[6] Ultimately, it held that the residence of the beneficiary alone did not supply the minimum connection to the state to sustain the tax, since the beneficiary lacked "control, possession, or enjoyment of the trust assets," with no right to demand any distributions or to direct any investments.

There are at least two important applications of *Kaestner* to Tennessee trusts.

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First, the Tennessee Hall Income Tax, which like North Carolina looks solely to the residence of the beneficiary as the basis for taxation of trust income,[7] may no longer tax undistributed trust income where the only Tennessee connection is the residence of the beneficiary. Trusts that have previously paid the Hall tax solely on this basis, without other minimum contacts with Tennessee, may file for refunds if within the statute of limitations.

Second, and far more importantly, only a few states do not tax trusts,[8] which makes those states attractive as trust residences when there are sufficient contacts with one of those states. The Tennessee Hall Income Tax will be fully repealed effective Jan. 1, 2021. By soon becoming one of only nine states (and the only state in the southeast besides Florida) not to tax trusts, Tennessee may even more likely become a haven for trusts created by out-of-state grantors.

Special Purpose Entities (SPEs) as Trust Protectors

In 2013, the Tennessee Uniform Trust Code (TUTC) was amended to add language about the use of Trust Protectors and Trust Advisors (hereinafter "Protectors")[10] in Tennessee trusts,[11] explicitly making such Protectors fiduciaries.[12] Only an individual or a corporate fiduciary could serve as a Protector.

But who would ever want to serve? Although Protectors have the same right to reasonable fees as trustees,[13] the body of law on Protectors' fiduciary duties is far less settled, potentially creating greater exposure to liability. Individuals could rarely if ever obtain individual liability insurance, other than attorneys or accountants.

Effective May 10, 2019, a Protector may be an LLC, to be known as a "Special Purpose Entity" (SPE), if it meets certain requirements.[14] The trustee of the trust must be a Tennessee corporate trustee, but the LLC may consist of one or more individuals. Such an LLC may be only thinly capitalized, or perhaps have no capital at all, thus effectively reducing the risk of liability for breach of fiduciary duty. It may also provide continuity in the event of an individual Protector's death or disability. The cost is an initial fee of $1,000 to the Department of Financial Institutions plus an annual renewal fee of $1,000. In the context of the *Kaestner* decision discussed above, where it may be desirable for state income tax purposes to maintain exclusively Tennessee connections to the extent possible, a Tennessee SPE would give Tennessee resident status to nonresident Protectors.

Nonjudicial Modification of an Irrevocable Trust: Goodbye, Claflin?

Prior to adoption of the Tennessee Uniform Trust Code (TUTC) in 2004, an irrevocable trust could not be modified or terminated without a court order. A limit on any such action was the *Claflin*[15] doctrine, that a court may not modify or terminate an irrevocable trust, even if all beneficiaries consent, unless the modification or termination would not be contrary to a material purpose of the trust.

A useful tool under the TUTC as initially enacted was greater flexibility to modify existing irrevocable trusts. If the grantor were still alive, no court order was required as long as the grantor did not object after receiving notice, since the grantor could decide for himself whether there was any material purpose. If the grantor were deceased, however, a modification still required a court order and the application of the *Claflin* doctrine.

Effective May 10, 2019, if the grantor is deceased, a trust in Tennessee may be modified without court order by the unanimous agreement of the trustee and all qualified beneficiaries, "if such modification does not violate a material purpose of the trust."[16] In other words, the trustee and beneficiaries may now determine for themselves, by unanimous vote, whether there remains any material purpose that would be violated by the modification. This risks putting the fox in charge of the hen house.

A draftsman for a concerned grantor might try to alleviate this concern by including a clause prohibiting any modification without a court order and satisfaction of the *Claflin* doctrine. However, after the grantor's death, the trustee theoretically could unilaterally "decant"[17] the trust to another trust that does not contain such a prohibition, without any participation by the beneficiaries, providing cover for an end run around the grantor's explicit desire. Or following the trend in increased flexibility and power by trust beneficiaries, there may be further amendments to Tennessee trust law that increase the ability to modify, despite a grantor's express wishes to the contrary. Ultimately, grantors' dead hands may be losing their grip.

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NOTES

1. Examples of Tennessee trust law changes include adoption of the Uniform Trust Code (2004); decanting power (2004); extension of the rule against perpetuities period to 360 years (2007); Tennessee Investment Services Trusts (i.e., domestic asset-protection trusts) (2007); community-property trusts (2010); directed trusts (2013); trust protectors and trust advisors (2013); and tenancy-by-the-entirety trusts (2014).

2. It is fascinating that many of the changes to Tennessee trust law have either originated or been endorsed by the Tennessee Bankers Association, which promotes its role in doing so. In some states, bankers' associations have actively fought these kinds of changes, concerned that such laws increase

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