The state of your trust: where should a trust be sited?

All of us know the mantra…in buying a home, it's location, location, location. Deciding where to site a business or build a new facility? You'd be examining elements like local laws, available labor, and tax climate. Where to retire? Similar line of thinking.

Yet when approaching estate planning and, more specifically, setting up a long-term, irrevocable trust, many high net worth families both think and act locally. They provide -- often with minimal analysis or advice – for a trust that is governed by the laws of their home state and subject to taxation there, without considering alternatives that may be far more attractive.

As some states have modernized their trust laws and expanded the options available to a trust donor, knowing those options and making an informed choice about where to site a trust is more important than ever. So is building flexibility into your plan, such as empowering trustees to change the legal situs of a trust if the circumstances warrant it, all without undercutting your estate planning objectives: no small feat.

So, what are the key issues? What planning goals or differences in state law might lead you to establish a trust in State Y over State X?

Here are six factors to consider when deciding where to site a trust and what governing law to choose:

1. Taxes, taxes, taxes

While some donors set up trusts in part to reduce estate taxes, it is also important to think through how the trusts will be taxed for state income tax purposes. Many states, such as New York, California, North Carolina, Illinois, New Jersey, Pennsylvania, Massachusetts and Indiana, levy income taxes on non-grantor trusts (that is, trusts that bear their own taxes) that reside locally. In Massachusetts, for example, trusts must be established as "non-resident" to avoid Massachusetts income tax. This can be accomplished by selecting a trustee located in a jurisdiction outside Massachusetts, even if the donor lives in-state.

Additionally, the laws governing whether a trust "resides" in a particular jurisdiction vary from state to state, making for a confusing patchwork of rules. For example, in California and Connecticut, the residence of the trust beneficiaries is an important factor. In New York and Massachusetts, the residence of the trustee is paramount. These rules must be considered before establishing the trust; they are also subject to change, particularly as states look for revenue.

As for trusts already in existence, you may be able to move a trust to a more favorable tax state. Doing so depends on the taxing state's rules for determining the trust's residency. For income generated from a trust-owned business or asset physically located in a certain state, it will likely be impossible to escape that state's income taxation. But, for example, under current law, a trust with a New York trustee that holds only publicly traded securities and has no New York source income and no assets situated in New York will be able to escape New York's income tax by having the New York trustee replaced with a trustee based in a non-tax state, such as New Hampshire or Delaware.

2. Maintaining control over trust management

Obviously, selecting the right trustee and giving them the powers needed to carry out their responsibilities properly is essential to trust planning. Frequently, the trustee chosen will have the necessary combination of investment expertise, understanding of family dynamics, and attention to administrative detail necessary to do the job, whether alone or with a co-trustee.

There are, however, certain situations in which a donor might decide that a division of trust duties is desirable. For instance, a family business owner who has transferred most of the company's shares into a trust may want to keep management of those assets with a trustee who has intimate, first-hand experience with the business, while delegating the administration and investment of other trust assets to a second trustee. Or a donor may wish for a corporate trustee to manage record-keeping and all investment functions of a trust, but prefer to choose a relative or family friend to make distribution decisions.

Trusts that provide for such a division of trustee responsibilities (often referred to generally as "directed trusts") can be a helpful solution where the specific circumstances call for it--but not all states allow them – and some that do might not allow the full breadth of options. States such as Alaska, Nevada, New Hampshire and Delaware have statutes authorizing the use of directed trusts in a wide variety of contexts.

3. Changing goals, changing trusts through a decanting statute

Trusts are designed to meet specific family goals, but unanticipated circumstances might cause a donor to desire changes to the original terms of the trust. Even if a trust is irrevocable, changes

may be able to be made through “decanting,” that is, paying over the trust assets into a new trust with different provisions.

There are many instances where this may be desirable. For instance, the donor may have established a trust that called for a mandatory payment of a certain percentage of assets to a beneficiary upon the beneficiary’s attainment of a certain age. While that percentage and/or age may have seemed appropriate at the time of establishing the trust, it could be that the assets have appreciated beyond expectations, or that the beneficiary may not be able to handle assets outright, making the mandatory payout undesirable. Many states have statutes allowing decanting that would enable the payment of assets to a new trust that scales back the mandatory payout, postpones it to a later age, or eliminates it altogether.

Even if one has a current trust sited in a state with no decanting statute, it may be possible to achieve the same outcome by a 2-step process, in which the situs of the trust is first moved to a state that allows decanting, and a decanting is then effected under the laws of the transferee state.

As of the date of this writing, 21 states have passed decanting statutes.

4. Keeping the trust Quiet

People often worry that the development of their children’s or grandchildren’s work ethic will suffer if he or she knows of a pending inheritance. This fear can be a real disincentive to many donors who might otherwise wish to establish trusts for family members (for instance, to achieve tax objectives), because their state law likely requires trustees to provide beneficiaries with detailed information about the trust assets. That donor may be more comfortable establishing a “quiet trust” in a jurisdiction that allows them. With a quiet trust, the donor may be able to provide that the trustee is not obliged (or is even forbidden) to notify the beneficiary of the existence of the trust, let alone its value or terms.

Most states do not have statutes authorizing quiet trusts, and in fact require that significant disclosures be made to beneficiaries at regular intervals. States that authorize quiet trusts, on the other hand, may enable the donor or trustees to decide what information will be provided, and when. Some such states allow quiet trusts without limitation; others allow them but limit the “quiet” phase in some fashion, such as by the age of the beneficiary or during the donor’s lifetime.

5. Protecting assets from creditors

Asset protection is a major concern for many donors, and “spendthrift trusts” are traditionally used to build in protection for trust beneficiaries against creditors, including spousal creditors. Parents who worry about the possibility of a child’s divorce may wish to ensure that trust assets will not be accessed by a potential ex-spouse in a divorce settlement. A spendthrift trust allows the trustees

full control over how distributions are made, and creditors will not be able to assert any claim over the trust assets.

More recently, some states have provided for self-settled spendthrift trusts. In these cases, grantors can list themselves (and third parties, if they choose) as the beneficiaries. Approximately 14 states, including New Hampshire and Delaware, now offer asset protection statutes for self-settled trusts.

6. Perpetual trusts

For wealthier donors, a primary intention in establishing an irrevocable trust may to be to set aside a pool of money that will benefit many generations to come. However, most states have laws limiting the duration of trusts. This may eliminate the usefulness of the trust vehicle for a donor, particularly if the donor feels that he or she has already provided adequately for children and grandchildren.

Such a donor could consider establishing a trust in a jurisdiction that has eliminated (or never had) a rule against perpetuities. By funding an irrevocable long-term trust in a jurisdiction that allows perpetual trusts, and allocating the donor's exemption from generation-skipping transfer tax to the transfer, the donor may be able to establish a trust fund that benefits a large number of generations to come, while avoiding the imposition of any transfer taxes on the trust assets at any generational level.

Know your options

In sum, family goals take all shapes and sizes, and when it comes to using trusts to help accomplish such goals, the location of the trusts can make all the difference. While setting up a trust in the "wrong neighborhood" might not have beneficiaries someday living alongside a new super highway or freight line, they may nonetheless wish that the trust was in another location, location, location.

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