States Want Your Trust

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If you're considering establishing a trust, it may pay to shop out of state.

About half a dozen states are actively vying to attract wealthy families' trusts, as well as the jobs and tax revenue that come from the companies that administer these estate-planning vehicles.

States such as Alaska, Delaware, Nevada, New Hampshire, South Dakota and Wyoming have modified their trust laws in recent years to make them more attractive to individuals and families, including nonresidents, looking to minimize taxes, shield assets from creditors and preserve family assets in the event of a divorce, among other things.

While the competition among states for trust business ultimately helps consumers, parsing the differences between state trust laws and separating hype from fact can be a challenge. "There's a whole lot of trash talking going on," says Richard Nenno, a managing director and trust counsel at Wilmington Trust Co. in Delaware. "It makes it difficult for people to cut through to what really matters."

When contemplating a trust—an agreement in which an individual or institution (the trustee) agrees to manage your assets for your beneficiaries—the first step is to determine with the help of an attorney what you are trying to accomplish. Next, examine which states' laws are best-suited to your needs. Because setting up a trust in another state can involve additional expenses, some families and individuals may not have enough wealth to make it worth their while. But for those who do, many trust lawyers say the only real requirement is that they choose an in-state trustee.

A state's tax laws and how long the state allows a trust to remain in existence are important considerations when deciding where to set up a trust. A minority of states, including Alaska, Nevada and South Dakota, don't tax trust income at all. Other states, such as Delaware, impose taxes only on in-state beneficiaries. New Hampshire lawmakers recently amended legislation to make clear that out-of-state trust beneficiaries aren't subject to state taxes.

About half of the states and the District of Columbia have abolished or modified their laws to allow trusts to last for long periods. That means assets in a properly structured trust can continue growing for hundreds of years, or indefinitely in some places, free of estate, gift and generation-skipping taxes, which can consume about half a trust's assets.

"At the end of the day, the taxation is a big factor," says Scott Baker, principal at Perspecta Trust LLC in New Hampshire, a state that is an aggressive participant in the trust race.

Among other factors to consider when shopping around for an attractive trust jurisdiction are flexibility to modify trusts and move assets between trusts, as well as state courts' familiarity with trust-and-estate cases.

Many people set up trusts to gain asset protection. Doctors and business owners, for example, may want to shield assets from creditors, while parents may want to ensure assets stay within the family if their children or grandchildren divorce.

"Creditor-protection techniques are becoming increasingly popular in the U.S.," says Nevada estate-planning attorney Julia Gold. "We live in a litigious society."

Companies responsible for administering trusts, investing trust assets and making decisions about distributions typically charge around 1% of assets for smaller trusts—say, those with a few million dollars. The percentage typically declines as the asset level increases.

Between 1985 and 2003, some $100 billion—about 10% of reported trust assets held by federally regulated financial institutions—moved to states that allowed long-term trusts and didn't tax trusts created by nonresidents, according to a study by Robert Sitkoff, a professor at Harvard Law School, and Max Schanzenbach, a professor at Northwestern University School of Law, published in the Yale Law Journal.

Since that study, states have tried to differentiate themselves further in an effort to attract more trust business.

According to Mr. Sitkoff, at least three states—Delaware, New Hampshire and South Dakota—have enacted laws that protect trustees from liability in the event the person who created the trust (the grantor) instructs the trustee not to diversify certain assets. Trustees in most states generally are required to diversify trust assets for risk-management purposes, though exceptions are made for illiquid assets like family businesses or real estate.

States also have different rules regarding trustees' obligations to disclose information to trust beneficiaries. Many senior family members worry that children and grandchildren who know they're going to receive significant sums of money won't be motivated academically or professionally, so they seek to keep the existence of a trust secret. Still, some attorneys and courts are uncomfortable with the withholding of information from beneficiaries, says Dana Fitzsimons Jr., a Virginia trust-and-estate attorney.

Really wealthy families—those with $100 million or more—might consider establishing a private trust company in states that allow them to do so, such as South Dakota, Nevada and Wyoming, say attorneys. The family then has a say in trust decisions and isn't limited to the investment products offered by a trust company.

"The whole issue is control," says Mark Merric, a Colorado estate-planning attorney, who along with Florida attorney Daniel Worthington published a journal article earlier this year on the most trust-friendly states. (Mr. Worthington serves on the audit committee and board for South Dakota Trust Co.)

Anyone contemplating an out-of-state trust can continue using an in-state attorney. The in-state attorney can draft trust documents and have a lawyer licensed in the more trust-friendly state confirm that they comply with and take full advantage of that state's laws.

If you ask about out-of-state options and your trust-planning professional gives you "a blank stare, I'd go elsewhere," Mr. Merric says.