South Dakota Trust Law: Pulling Back the Curtain
A Soup to Nuts Tour of South Dakota Trust Law
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I. INTRODUCTION

South Dakota is home to one of the top trust jurisdictions in the world. That's a big claim. The purpose of this presentation is to pull back the curtain on why South Dakota has attained the status of a preferred trust destination for wealthy families. It will also explain why South Dakota Trust law is attractive to advisors who recognize implementing South Dakota trust techniques do not elbow the advisor out of the planning process. Instead, South Dakota law invites the advisor to play a significant role in a South Dakota trust and strengthens their relationship with the client. This outline will take you on a soup to nuts tour of South Dakota trust law illustrating the South Dakota advantage.

A. SD TRUST INDUSTRY - RANKINGS, NUMBERS & THE TRUST TASK FORCE

As your presenters are, in fact, South Dakotans, you are justified in acknowledging our bias in declaring South Dakota as one of the top trust jurisdictions. So, don't just take our word for it. Instead, examine what others have said about South Dakota as a top trust jurisdiction and the results produced by the trust rush to South Dakota.

In support of labeling South Dakota as one of the top trust jurisdictions, take note of the annual article published by *Trust & Estates* periodical, which compares and ranks the laws of each state that actively competes for clients to utilize the trust laws of their state. Since the inception of the rankings in *Trust & Estates*, South Dakota has finished in the top tier every year. In fact, in 2007, prior to grouping the states by tiers, *Trust & Estates* ranked South Dakota as the number one trust jurisdiction. Worthington & Merric, "Which Situs is Best in 2016?" *Trust & Estates*, Jan 2016, at 61 – 63. Worthington, "Perpetual States – The Latest Rankings: A Guide to Picking the Best Jurisdiction for Your Client." *Trust & Estates*, Jan 2007, at 59. *See generally,* Patrick Goetzinger, *A Dynamic Duo: South Dakota's Trust Laws & Business Entity Statutes,* 61 S.D. L.REV. 339 (2016).

The April 13, 2013 edition of the *fedgazette* publication teased us with the headlines, "In South Dakota, we trust," and "Why trust anywhere else?" The article stated, "South Dakota's large share of this growing market is the product of trust-friendly state law and regulation, part of a pattern of widely recognized friendliness to business."

B. STRONG ECONOMIC BASE ATTRACTS CAPITAL

Let's take a tour of the numbers illustrating South Dakota's strong economic infrastructure and the capital it attracts. In 2016, SD led the nation in total bank assets with $2.9 Trillion. Next was Delaware with only $980 Billion and New York with $934 Billion.

South Dakota has a constitutional requirement to balance the state budget annually, and does so (most of the time) without raising taxes and avoiding structural budget deficits. In addition, SD constitutionally prohibits the taxation of inheritances, which is a much stronger bar to the whims of a legislature who may seek to tax inheritances as the federal government cedes ground on the federal estate tax. SD further enjoys a Triple A Bond Rating, a fully funded and healthy state retirement fund earning it a place in the top 1% of public pension fund performance, and does not have a personal income tax, corporate income tax, capital gains tax or intangibles tax.

C. GOVERNOR'S TASK FORCE ON TRUST ADMINISTRATION & REFORM

The growth of South Dakota's trust industry is remarkable, but not accidental. The steady growth of the trust industry began when Governor Janklow created the Governor's Task Force on Trust Administration Review and Reform ("TTF") in 1997. The TTF is composed of representatives from the trust industry, the Bar and state government. This partnership effectively works together to enhance South Dakota's trust laws in a balanced and prudent fashion. No other state has such a partnership. Formation of the TTF demonstrates the importance of the trust industry to South Dakota and the commitment of the state to preserve South Dakota's status as a top trust jurisdiction.

"Openness to trusts was kick-started [when the TTF] began laying a regulatory foundation that was rigorous yet welcoming to trust companies..." *fedgazette* article, cited supra, at page 13. The TTF confines its scope of duties to recommendations relating to South Dakota trust law and regulations. The TTF analyzes what other states are doing and what SD can do better to remain among the top trust jurisdictions. *Id*. The work of the TTF annually produces an array of modern trust statues fortifying South Dakota's already robust set of trust laws.

In addition, the South Dakota State Bar Business Law & RPPT Sections and the South Dakota Trust Association compliment the work of the TTF and enhance SD's desirability as a trust destination by tending to SD's business laws and other estate planning related statutes.

Trust friendliness should not be confused with total deregulation and inviting undue risk. Like banks, SD trust companies pay annual fees to the state to support a regulatory system that employs examiners and auditors to analyze the companies for soundness and cleanliness. *fedgazette* article cited supra, at page 13. The SD Division of Banking also maintains a fund to guard against a resolution risk. Trust companies are assessed a percentage of assets under management to maintain the fund. ARSD 20:07:22:01.

D. THE NUMBERS - THEY ARE IMPRESSIVE

Tangible evidence of the effectiveness of SD's economic environment, tax policy (or lack thereof), as well as the careful attention to SD's business laws and trust laws is illustrated in the numbers associated with SD's trust industry. As of September 2018, South Dakota had 99 state chartered private and public nondepository trust companies providing fiduciary services only. No other state has more. As of the end of 2017 these trust companies had a total of $293.5 Billion in assets under management. Note, these numbers do NOT include depository banks with trust departments. Doing so would swell these numbers even more.

For comparison, in 1997, SD had 3 state chartered trust companies with less than $1 Billion under management. In 2011, SD had 55 state chartered trust companies with $104 Billion under management. What better endorsement can be given to a trust jurisdiction?

II. DISTINCTIVE SOUTH DAKOTA TRUST LAWS

South Dakotans gratefully acknowledge others who have provided ideas for legislation implemented in South Dakota. Applying South Dakota's populist viewpoint, SD has put its unique imprint on ideas developed elsewhere. Moreover, SD has pioneered several innovations in modern trust law, as this outline will discuss.

A. GRANTOR SOVEREIGNTY - THE LYNCHPIN OF SD TRUST LAW

Guiding South Dakota's legislative approach and a key distinguishing feature of South Dakota trust law is the lynchpin concept of grantor sovereignty. SD statutorily recognizes that she who has the gold makes the rules. The bedrock of grantor sovereignty assures trust terms reflecting the grantor's wishes will be respected. It provides grantors with tools to protect assets from the hazards of life and from those who prey on family members or others the grantor deems the beneficiary of her assets. Grantor sovereignty is the mindset that provides planning options to protect trust assets and beneficiaries from predators, creditors, in-laws and outlaws. Goetzinger, *A Dynamic Duo: South Dakota's Trust Laws & Business Entity Statutes,* 61 S.D. L.REV. 339 (2016) at p. 345. Grantor sovereignty principles presents the grantor with the legal right to control investment, distribution and management decisions by authorizing the trustee to hold high risk investments, business interests with no duty to diversify and employ subjective distribution standards.

The lynchpin of grantor sovereignty enjoys a twenty year tradition of being preserved and enhanced in South Dakota trust law. The term "grantor sovereignty" is attributed to former State Senator Dave Knudsen, who was Co-Chair of the TTF for several years while he was in the South Dakota State Senate. Id. Grantor sovereignty stands in stark contrast to state statutory regimes that favor beneficiary rights.

The following statutes provide statutory support of South Dakota's commitment to grantor sovereignty: (i) SDCL 55-4-30, which sets forth broad powers of the grantor of a trust; (ii) SDCL 55-5-12, which authorizes the grantor to expand, restrict, eliminate or otherwise alter by express provisions in the trust instrument the investment and management powers of a trustee; (iii) SDCL 55-1B-1.1, which authorizes the grantor to construct a directed trust arrangement as set forth in the trust instrument; and (iv) SDCL 55-1-53, which authorizes the grantor to expand, restrict, eliminate or vary provisions of general application to trusts and trust administration, except as set forth in SDCL 55-4-11 & 55-4-12 (which address trustee self dealing topics).

B. PRIVACY SEAL

Recognition of the desire for privacy of the grantor's affairs prompted the TTF to author legislation in 1998 providing for the most robust privacy seal in the nation for South Dakota trusts, which was further strengthened in 2016. SDCL 21-22-28. South Dakota's privacy seal is absolute and permanent under SDCL 21-22-28. In contrast, other states do not have an absolute shield and the duration of the seal is for a term of years, not in perpetuity. For example, Delaware only has a 3 year privacy seal. Further, South Dakota does not have statutory or regulatory requirements to register a trust or report on trust income activity for state tax purposes because South Dakota has no state income tax.

In 2017, the South Dakota Legislature added a series of statutes to SDCL Chap. 55-1 that provides for the purely optional registration of trusts to accommodate the wave of international trusts changing their situs to South Dakota. The new law specifically states the trust registration shall be sealed and kept confidential.

C. PRIVACY DISTINGUISHED FROM SECRECY

In the wake of the Panama Papers headlines in 2016, it is important to distinguish between privacy and secrecy and understand where South Dakota falls. South Dakota is not a jurisdiction to hide assets in secrecy. South Dakota does not have the total secrecy features of offshore jurisdictions, Nevada or Wyoming. On the other hand, South Dakota places a premium on confidentiality and honoring a grantor's desire to keep their affairs private.

South Dakota trust companies are subject to regular audits by the SD Division of Banking. Auditors review the records of the trust company for fiscal soundness, and adherence to policies designed to identify bad actors misusing SD's trust laws for unlawful purposes. SD is not willing to sell out or compete in the race to the bottom on secrecy matters preferring instead to offer firm, but fair regulation of the trust industry which strikes the proper balance between the goals of the grantor and protecting the state's reputation.

D. QUIET TRUSTS

In some cases, the grantor has good reason to limit the beneficiary's right to information about the trust, withhold the existence of a trust or the details about its holdings from the beneficiaries. The reasons might include waiting until the beneficiary attains a certain age or achieves specified goals. More importantly, the grantor needs no reason at all. In such cases, a quiet trust is desirable. SDCL 55-2-13 allows the grantor to waive the trustee's obligation to notify the beneficiary of a trust that the trust exists and provide a copy of the trust to the beneficiary. The quiet trust provisions of other states are not as clean as what are provided for in SD.

E. PRE-MORTEM TRUST CHALLENGES & ENFORCEMENT OF NO CONTEST PROVISIONS

South Dakota is one of a few states that allows for a pre-mortem trust challenge and enforces no contest clauses in trusts providing grantors with powerful new weapons to deal with disgruntled family members and beneficiaries. SDCL 55-4-57; SDCL 55-1-46 thru 55-1-50.

F. THE NORTH STAR LEADING TRUSTS TO SOUTH DAKOTA - SITUS RULES

The benefits and features of South Dakota law discussed throughout this outline are only available to trusts that are sitused in South Dakota. That is, the trust must be actively administered in South Dakota by a qualified South Dakota trustee. SDCL 55-3-39 through 55-3-43; SDCL 55-3-46; SDCL 55-3-48; SDCL 51A-6A-11.1; and ARSD 20:07:22:04 all address how to establish SD situs for a trust. Typically, naming one of South Dakota's state chartered trust companies or banks with SD trust powers will establish South Dakota situs.

As the tour of South Dakota trust law continues in this outline, additional distinctive features will be revealed.

III. SOUTH DAKOTA DYNASTY TRUST - THE GRANDDADDY OF THEM ALL

A. A BRIEF INTRODUCTION TO THE DYNASTY TRUST

The Dynasty Trust is also known as a Perpetuities Trust, Perpetual Trust or a Legacy Trust. It is a trust that is designed to last forever, or for a good long time throughout several generations. Grantors may allocate their GSTT exemption to a Dynasty Trust so that the assets transferred to the trust will remain exempt from federal transfer taxes for as long as the assets remain in the trust.

The Dynasty Trust will also contain spendthrift provisions protecting trust assets from creditors, predators, in-laws and outlaws. The options regarding the use of the Dynasty Trust are many and varied and left to other articles. No matter the status of the prospect of repeal of the federal estate tax, the advantages of a Dynasty Trust will continue to be an indispensable tool in the arsenal of planning options to achieve a grantor's planning objectives.

B. THE BEGINNING OF THE DYNASTY TRUST ERA

Many states now market dynasty trusts, but only one state can say they were the first state to authorize dynasty trusts - South Dakota. Every state enacted the Rule Against Perpetuities ("RAP"), which prohibits assets from being held in trust beyond the time frame set forth in statute or the state's constitution. South Dakota repealed its RAP statute in 1983. SDCL 43-5-8 simply states, "The common-law rule against perpetuities is not in force in this state."

Some states participating in the rush to repeal the RAP have failed to assure their statutory repeal squares with the provisions of their state constitution. This deficiency was spotlighted in Steven Horowitz and Robert Sitkoff's article, “Unconstitutional Perpetual Trusts,” 67 Vanderbilt L. REV. 1769 (2014). The article analyzed state statutes that repealed the RAP comparing the statutory repeal with the state's constitution. Surprisingly, several states that statutorily repealed their RAP had constitutional provisions that prohibited perpetual trusts. The contradiction between some state statutes and their constitution has placed the effectiveness of the statutory repeal of the RAP in serious doubt. Among the state's that market themselves as a premier trust jurisdiction, Nevada, Wyoming and Tennessee were singled out by the article as state's where the statutory repeal of the RAP conflicted with their state constitution. On the other hand, the article noted that the 3 states where their statutory repeal was aligned with the state constitution are South Dakota, Delaware and New Hampshire.

Where is your client's Dynasty Trust sitused? Where do you want it to be sitused? What duty do you owe your client on advising about the jurisdiction they are exploring for the formation of a Dynasty Trust? The parade of potential horrors associated with a Dynasty Trust formed in a jurisdiction where the authority for such a trust is in doubt include: Attorney fees incurred to defend the trust. Was the transfer to the trust in the first instance proper? If the transfer is not found to be proper, can the beneficiary or their creditors and predators break the trust? Will the grantor's GST and gift tax exemptions be wasted?

C. THE SOUTH DAKOTA DYNASTY TRUST ADVANTAGE

Other than claiming the status as the first dynasty trust jurisdiction and a perfect alignment between statutory repeal and the state constitution, what distinguishes SD as a preferred dynasty-trust jurisdiction? South Dakota's repeal of the RAP in 1983 predates the imposition of the GSTT in 1986, which distinguishes SD as one of 2 states (Wisconsin is the other) to have a statutory repeal prior to 1986. Some commentators assign significance to this timing in the event a court or the IRS assign significance to the intention behind a state's repeal was to circumvent the imposition of federal tax.

Unlike Wisconsin, SD has no state income tax to erode the annual earnings of the trust. The compounding effect of a South Dakota Dynasty Trust is enormous and proved irresistible. *See generally,* Pierce McDowell, "The Dynasty Trust: Protective Armor for Generations to Come," *Trust & Estates*, Oct. 1993.

Even with the prospect of the repeal of the FET, there is little doubt the FET would be restored by a future Congress and administration. In the meantime, it is logical to expect revenue hungry states will implement state estate or inheritance taxes to fill the vacuum. State budgets are stretched and running structural deficits. Legislators are challenged to find new revenue sources. Expect to see more state's introduce legislation to claim the tax revenue ceded by the federal government on the transfer of wealth.

However, South Dakota will not be among those states because SD has a constitutional prohibition on imposing any tax on an inheritance and specifically forbids the legislature from enacting any law imposing such a tax. SD Constitution, Article XI, Section 15 (2001). In order to amend the state constitution, a vote of the people approving the amendment is required.

Grantors have available to them the directed trust model (discussed infra) and grantor sovereignty principles to incorporate into the trust instrument providing the opportunity for a personalized trust designed to meet the grantor's unique goals and objectives – forever.

Pairing a South Dakota Dynasty Trust with a South Dakota LLC or LP provides a dual shield to protect the assets from attack by nefarious characters. The sole and exclusive remedy of the charging order in South Dakota's LLC and LP statutes is ranked as the best in the nation. The first shield wraps the closely held business interest, portfolio of marketable securities or real property in a SD LLC or LP. The next shield is created when the units issued by the entity are transferred to a SD trust. The dual shield provided by the SD trust and limited liability entity creates a dynamic duo that stands as guardian and sentinel, vigilantly protecting the family's assets. Goetzinger, *A Dynamic Duo: South Dakota's Trust Laws & Business Entity Statutes,* 61 S.D. L.REV. 339 (2016) at p. 341.

IV. THIRD PARTY DISCRETIONARY SUPPORT TRUSTS

South Dakota's Third Party Discretionary Support Statutes codified in SDCL 55-1-24 thru 55-1-43 which introduces the concept of the kicked up spendthrift trust providing grantors with more tools to protect trust assets from a beneficiary's predators, creditors, in-laws and outlaws.

A. TERMINOLOGY PRIMER

We are all familiar with the concept of the Third Party Beneficiary Spendthrift Trust. Let's break that phrase down. The grantor forms a trust for the benefit of someone else. The distribution provisions of the trust do not mandate distributions to the beneficiary and any distributions are purely discretionary. The Trust would also contain a spendthrift clause using the magic words directed by state law. The desired result is to protect the assets of the trust from the beneficiary's creditor claims. If the challenges of life were that simple, end of discussion. But they are not, so we continue the tour of South Dakota's unique treatment of Third Party Discretionary Support Trusts to meet modern and ever evolving challenges.

South Dakota replaced its spendthrift trust statutes (all 4 of them) in 2007 with an entirely brand new, first of its kind in the nation statutory regimen. The new statutes provide rules for the Third Party Discretionary Support Trust now codified in 20 statutes, SDCL 55-1-24 through 55-1-43. The goal of the new statutory regimen is protecting trust assets from a beneficiary's creditor who utilize modern arguments in an attempt to pierce the trust.

Third Party Discretionary Support Trusts are distinguished from a self settled trust or domestic asset protection trusts, discussed infra. Third Party Discretionary Support Trusts are also distinguished from a pure support trust. A pure support trust does not protect the trust assets from the beneficiary's creditor claims. A pure support trust is one that mandates the trustee shall make distributions to the beneficiary and exposes the trust assets to the claims of a beneficiary's creditors - unless the trust is governed by South Dakota law, as discussed infra.

B. THE TRANSITION FROM A SPENDTHRIFT TRUST TO A KICKED UP THIRD PARTY DISCRETIONARY SUPPORT TRUST

Why change South Dakota's longstanding spendthrift trust statutes and seek distinction from the traditional notions of a spendthrift trust commonplace in other states? Courts have new authority available to interpret trust provisions and wily creditors are exploiting those authorities to pierce spendthrift provisions, employ alter ego arguments and put at risk trust assets previously thought not at risk. The new authorities include the Restatement of Trust (Third) and the Uniform Trust Code. These new authorities present a decidedly pro-creditor rights position introducing potential new paths to access trust assets to satisfy beneficiary creditor claims.

This new authority is in sharp contrast with common law and the Restatement of Trusts (Second). South Dakota's new 2007 statutory regimen codifies the common law and the approach taken by the Restatement of Trusts (Second) and specifically rejects the approach taken by the Restatement of Trusts (Third) and the Uniform Trust Code. SDCL 55-1-25. South Dakota was the first state to take such an approach. Where the language of a trust is not as precise as one would like to assure spendthrift protection, South Dakota's statutes provides counsel the opportunity to parse the language and find protection.

C. INTERESTS HERE, INTERESTS THERE, INTERESTS EVERYWHERE

Under the new rules, a trust does not necessarily need a spendthrift provision to protect the assets, though one is highly recommended. SDCL 55-1-35, 55-1-37 & 55-1-41. For the traditionalist, a spendthrift clause is specifically provided for in SDCL 55-1-41.

South Dakota's law makes clear distinctions between the type of distribution interest a beneficiary is granted under a trust – a mandatory interest, a support interest or a discretionary interest. SDCL 55-1-24. These distinctions can be used to block access to trust assets by a beneficiary's creditors who argue less than precise trust terms pry open access to trust assets. Under SD's law, the beneficiary's distribution interest defined by the trust terms can be dissected by the interests created. If an interest is classified as a discretionary interest the assets associated with the interest may be protected from creditor claims, irrespective of the type of trust in place and irrespective of whether the trust contains a spendthrift provision. SDCL 55-1-38; 55-1-39.

South Dakota's law includes specific statutory authority which provide additional creditor protections. South Dakota became the first state to declare a discretionary interest in a third party trust, a limited power of appointment and a remainder interest are not property interests that are available to a judgement creditor. Spendthrift protection is specifically extended to such interests. Neither a distribution interest nor a remainder interest is relevant in the equitable division of marital property. SDCL 55-1-30.

In the event a party challenges the grantor's or beneficiary's influence over the trust in an attempt to gain access to trust assets, several factors are disregarded in determining dominion and control over the trust. SDCL 55-1-32. In the event a party claims the settlor is an alter ego of the trustee, several factors are disregarded in that determination. SDCL 55-1-33.

D. SIMPLY – THE BEST

South Dakota's statutory approach has been lauded by commentators, which have consistently ranked South Dakota as among the top asset protection states, if not the best asset protection state. Mark Merric & Dan Worthington, "Best DAPT Jurisdictions Based on Three Types of Statutes, Where to set up these trusts," *Trusts & Estates*, Jan. 2017, page 64; Al King III, "The Trust Spendthrift Provision - Does it Really Protect?" *Trusts & Estates*, Dec. 2016, page 8.

V. DOMESTIC ASSET PROTECTION TRUST

A. TERMINOLOGY & LEGALESE MASK A REVOLUTIONARY CONCEPT

Domestic Asset Protections Trusts ("DAPT") are also known as self settled trusts. A self settled trust means an individual can transfer assets to a trust she forms; name herself as a beneficiary; and protect the assets from her creditor claims. A DAPT is distinguished from a third party discretionary trust where an individual forms and funds a trust for the benefit of a third party. See discussion, supra.

The DAPT statutes are codified in SDCL Chap. 55-16, entitled "Qualified Dispositions In Trust." This unfortunate name is confusing and disorienting. To those unfamiliar with the aliases for the DAPT, the title of the chapter camouflages a very effective trust planning tool. Mainstream discussion of DAPTs and self settled trusts does not include the terminology "qualified dispositions in trust." You will not find the term "self settled trust" or "domestic asset protection trust" anywhere in SDCL Chap. 55-16. SD's legislation is a classic example of a disconnection between brand marketing and code names.

B. BACKGROUND

The general rule nearly forever has been that creditors of a grantor who created a trust could reach the assets of the trust to satisfy their claims if the grantor retained the right to benefit from the trust. Restatement of Trusts (Second), Section 156(2). Offshore jurisdictions marketed trusts formed under foreign law as a technique to protect the grantor's assets in a trust that the grantor could also be named a beneficiary. However, going offshore, though exotic and alluring, had its own risks and disadvantages.

In 1997, Alaska was the first state to authorize DAPTs. Delaware was the next. After a long period of deliberation and due diligence by the authors of SD's DAPT statute, SD authorized DAPTs in 2005. Today 17 states have passed legislation authorizing DAPTs in one form or another.

In 2012, South Dakota, Alaska and Delaware were universally regarded as "The Big Three" among DAPT states. "Which Situs is Best?" *Trust & Estates Magazine,* Jan. 2012. Now, South Dakota, Ohio and Nevada enjoy the ranking in the first tier of DAPT rankings. Merric & Worthington, "Best DAPT Jurisdictions Based on Three Types of Statutes, Where to set up these trusts," *Trusts & Estates*, Jan. 2017.

C. QUALIFYING A TRUST AS A SOUTH DAKOTA DAPT

More terminology to absorb. The statute references “transferor”. A transferor is also known as a settlor or grantor. A transferor can also hold a power of appointment, or be a trustee with the power to make a disposition of trust assets. SDCL 55-16-1(8).

A transferor must make a qualified disposition, which means a disposition by a transferor to a qualified person by means of a trust instrument. SDCL 55-16-1(6). “Disposition” is also defined in SDCL § 55-16-1(4). It simply means a transfer, and a handful of other conveyances designed to allow the transfer of assets that may not be owned cleanly by an individual, into a DAPT.

“Qualified person” is defined in SDCL 55-16-3. Simply stated, a qualified person is a trustee qualified to act under SD law. Only one of the trustees needs to be a qualified trustee. The grantor may appoint Co-Trustees who are not SD residents or are not qualified trustees. SDCL

55-16-4. Furthermore, the grantor can appoint trust advisors, trust protectors and other fiduciaries defined in SDCL 55-1B-1(4). This feature allows flexibility by allowing the appointment of a SD trustee but involvement by the family members or other trusted advisors who may: (i) remove and appoint trustees and trust advisors; (ii) direct, consent to, or disapprove trust distributions; (iii) invest the assets of the trust; or (iv) vote stock or business interests. In certain cases, the transferor can hold the powers described above. SDCL 55-16-5.

A "trust instrument" is defined in SDCL 55-16-2. To qualify as a DAPT, the trust instrument <u>must:</u> (i) expressly incorporate SD law to govern the validity, construction, and administration of the trust; (ii) state the trust is irrevocable; and (iii) contain a spendthrift clause. SDCL 55-16-2(1) – (3). The statute further provides specific examples of language that may be contained in the trust instrument without spoiling the irrevocability of the trust instrument. SDCL 55-16-2(2)(a) – (j). These are powerful items that allow the transferor a measure of control over the trust without disqualifying the trust from protection against the transferor's creditors.

Permissible transferor powers include: (i) veto power over distributions; (ii) certain powers of appointment allowing the transferor to redirect the distribution of the assets both during the transferor's lifetime and after his/her death; (iii) principal distributions under certain circumstances; and (iv) replacement of trustees and trust advisors, under certain circumstances. While the transferor may retain some measure of control over the trust and its assets, the control will not expose the trust assets to the transferor's creditor's rights to the trust assets. SDCL 55-16-8 is a key statute to limit the transferor's control and the creditor's rights.

D. EXCEPTION CREDITORS – FRAUDULENT TRANSFERS & 6 MO/2 YR SOL

DAPTs will protect the trust assets against a creditor's claim, UNLESS the settlor's transfer of property was made with the intent to defraud that specific creditor. SDCL 55-16-9. This rule taps into the concepts discussed in fraudulent conveyance statutes found in the Uniform Fraudulent Transfer Act, SDCL Chap. 54-8A. The attorney should address with the client existing, pending or suspected claims against the client through the use of a Solvency Affidavit.

Additional exception creditors are codified in SDCL 55-16-10 where the 2 year/6 month SOL rules are located. If a creditor has a claim against a transferor that existed BEFORE assets were transferred to the DAPT, the creditor's rights are set forth in SDCL 55-16-10(1). It provides the assets of a DAPT are not protected from creditor claims if the creditor brings a fraudulent transfer claim within the later of two years of the transfer to the DAPT, or six months after the creditor discovers the transfer of assets to the DAPT, subject to very specific proof requirements. SDCL 55-16-10(1)(b)(i) & (ii). If a creditor becomes a creditor AFTER the assets were transferred to a DAPT, a fraudulent transfer action can be brought within two years after the transfer is made. SDCL 55-16-10(2).

Public notice of the transfer to the DAPT will trigger running of the SOL period, without regard to the date of discovery rules applied to a present creditor. This new development is heralded as a significant development in DAPT statutes. SDCL 55-16-10(4) & (5).

The creditor has the burden of proving they were defrauded by clear and convincing evidence. SDCL 55-16-10(3). The creditor cannot sue the trustee, trust advisor or trust preparer. SDCL 55-16-12. And if a creditor does sue, the court may award attorney fees. SDCL 55-16-13.

E. EXCEPTION CREDITORS – DOMESTIC CLAIMS

Notwithstanding all of the above, DAPTs will not protect assets from alimony obligations, child support obligations, or a property settlement division in existence at the time assets are transferred to the DAPT. SDCL 55-16-15.

If a transferor is married at the time of the transfer to a DAPT, the transferor must provide a notice of transfer to the transferor's spouse in the form prescribed by statute. SDCL 55-16-15(3). In other words, a spouse will not be an exception creditor if notice is given and the spouse does not object. It is further recommended having the spouse sign a document acknowledging notice has been given and no objection is made.

F. BANKRUPTCY

A federal bankruptcy statute adopted in 2005 declared that the grantor's creditors may access assets of a DAPT for a period of 10 years after the assets are transferred to the DAPT.

G. LIMITS TO A CREDITOR'S VALID CLAIM

Even if a creditor has a valid claim, SDCL 55-16-16 provides important guidance on what, precisely, is at risk or available to the creditor. The assets transferred to the trust (aka the qualified disposition at risk) is only at risk to the extent necessary to pay the creditor's claim, but only after the costs incurred by the trust (including attorney fees to defend the creditor's claim) have been paid from trust assets. A beneficiary who received a distribution before a creditor brings an action may keep the distribution from a DAPT unless he/she acted in bad faith. This is a notable exception to the rule that distributions from a spendthrift trust are not protected from creditor claims.

H. PLANNING OPTIONS WITH A DAPT

A DAPT can have multiple beneficiaries and can be a planning vehicle for the grantor's family. It can be structured as a Dynasty Trust and exclude assets from the grantor's estate. The DAPT can be used as a default marital agreement both before and after marriage, subject to the exception creditor rules discussed above. A DAPT can be a grantor trust, tax neutral trust and paired with SD limited liability entities, as discussed earlier. The DAPT can be structured as a hybrid DAPT – one that starts out without naming the grantor as a beneficiary, but gives a trust protector the power to add the grantor at a later time, a decision purely at the discretion of the trust protector.

I. CAUTIONS & THREATS

There are no SD cases on DAPTs. It is unsettled how an out of state court will view DAPTs. Will out of state courts declare DAPTs void against public policy? How will conflict of law principles apply where a judgment is obtained in another state?

A new threat entered the DAPT landscape in the form of the Uniform Voidable Transfers Act ("UVTA") adopted in certain states. In fact, Minnesota has adopted the UVTA. The UVTA may adversely impact the use of DAPTs by grantor's who reside in a state where the UVTA has been adopted by making transfers to the DAPT voidable. Merric & Worthington, "Best DAPT Jurisdictions Based on Three Types of Statutes, Where to set up these trusts," *Trusts & Estates*, Jan. 2017 at p. 73. Such a rule is contrary to most common law on such questions. Id.

The UVTA contains 2 areas prompting concern. The comments to Section 4 of the UVTA are one area of concern. My review of Minnesota's version of the UVTA suggests that comments are not incorporated into statute. The other section of concern is MN Stat. 513.485(b), which raises the prospect transfers to a DAPT are voidable. Fortunately, there are several arguments that should trump the application of the UVTA in a DAPT formed in another state. They include the full faith and credit defense, traditional conflict of laws analysis, and the strong public policy statements of the DAPT jurisdiction. Id. at p. 74.

South Dakota has several statutes that will assist in defending against the application of the UVTA to a SD DAPT. See SDCL 55-16-9, 55-16-10 and a new section added to SDCL Ch. 21-22. These statutes make SD's public policy regarding DAPTs abundantly clear and unambiguous and specifically provide for the application of SD law in any conflict of laws analysis.

J. A GAME OF CAT & MOUSE

As legislation drafters play a game of cat and mouse on versions of state laws that on the one hand protect assets, and on the other hand make assets available to satisfy creditor claims, there is no doubt the law will continue to evolve and create issues for lawyers to discuss with their clients. There is also no doubt asset protection planning will continue to be a hallmark objective of grantors. Utilizing a DAPT from a jurisdiction that employs fair and reasonable asset protection principles and strong conflict of laws features is essential to prevail in the game of cat and mouse.

VI. SPECIAL SPOUSAL PROPERTY TRUSTS (AKA COMMUNITY PROPERT TRUSTS)

Enhancing its status as a premier trust jurisdiction, South Dakota recently enacted legislation authorizing married couples to form a trust and achieve a 100% stepped up cost basis on trust assets specifically designated as community property. South Dakota joins Alaska and Tennessee as the only states specifically authorizing such trusts. Neither Delaware nor Nevada authorizes SSPTs or community property trusts.

These trusts have become popularly known as the Community Property Trust. In an effort to distinguish South Dakota's version of the trust, South Dakota legislation refers to its trust as the Special Spousal Property Trust ("SSPT"). Assets owned by a SSPT can be designated as community property under IRC Section 1014(b)(6) for tax purposes. SDCL 55-17-5. The ability to designate assets as community property and achieve the resulting stepped up cost basis associated with community property is indeed special. This summary briefly discusses the background of the SSPT, creating a SSPT, its planning applications and, finally, the risks associated with using a SSPT.

A. BACKGROUND

How the laws of each state treat marital property fall into 2 general categories: community property states and common law property states. Married couples who reside in a community property state have the tax advantage of receiving a 100% stepped up cost basis on community property upon the first spouse's passing. IRC Section 1014(b)(6). That's a powerful advantage. There are only nine community property states. South Dakota is not one of them; neither is Alaska or Tennessee. South Dakota is a common law state. Married couples who reside in a common law state and own property jointly will receive a stepped up cost basis on only 50% of the jointly owned assets. IRC Section 1014(a).

South Dakota's newly enacted SSPT legislation offers married couples the option to benefit from the powerful advantage of the community property designation. The South Dakota law authorizes a married couple to form a trust which specifically designates assets held by the trust as community property and achieve a 100% stepped up cost basis on the death of the first spouse. Married couples need not be residents of South Dakota to form a South Dakota SSPT. Any married couple can form a SSPT in compliance with South Dakota law.

B. THE ROADMAP TO COMMUNITY PROPERTY BY DESIGNATION

SDCL Chapter 55-17 furnishes the road map to create a SSPT. The trust must expressly designate some or all of the trust assets as special spousal property (aka community property). The trust must contain required disclosures and consent language in the manner provided for by South Dakota law. The trust must be signed by both spouses. State law gives helpful guidance on other matters that can be addressed in a SSPT and furthers South Dakota's preference for grantor sovereignty in drafting a trust instrument. If a trust holds assets designated as community property and also holds assets that are not community property, the trustee must observe proper record keeping in order to identify which property is designated as community property and which property is not. Another important requirement for a qualified SSPT is the appointment of a qualified South Dakota Trustee of the trust. A qualified South Dakota trustee is either a South Dakota resident, a South Dakota chartered trust company, or an entity with South Dakota trust powers. SDCL 55-17-1, 55-3-41, and 55-3-39.

C. PLANNING APPLICATIONS

The SSPT presents several planning applications. Initially, a significant advantage is the elimination of the guessing game on the order of death for a married couple. As a result of the

100% stepped up cost basis on the first spouse's death, planning decisions tied to speculating which spouse will die first are resolved by using a SSPT.

Any low cost basis capital assets, whether real property, marketable securities, tangible personal property or family business interests, are ideal assets to transfer to a SSPT. The SSPT can be integrated with a variety of trusts authorized under South Dakota law adding more value to such trusts. They include:

- Irrevocable Trusts
- Revocable Living Trusts
- A trust that holds both designated community property and non-community property
- Domestic Asset Protection Trusts
- Legacy, Dynasty or Perpetuities Trusts
- SD ING Trusts
- Grantor Trusts & Non-Grantor Trusts
- Spendthrift Trusts

Furthermore, couples who reside in community property states can now form a SSPT under South Dakota's advantageous trust laws and fund it with community property without giving up the advantages of the original community property designation by incorporating the SSPT rules in their new South Dakota trust. It is also possible to modify, reform, or decant an existing trust to incorporate the SSPT language and attain community property status on designated trust assets.

South Dakota law promotes flexibility in drafting a SSPT. The terms of a SSPT can define the rights and obligations of the beneficiaries to the trust property, management rights of the property, disposition of the assets on the termination of the trust, how the trust can be amended and any other matter as long as it does not violate public policy or a statue imposing a criminal penalty. SDCL 55-17-9. However, a SSPT cannot affect child support obligations or certain creditor rights, and the SSPT cannot affect the duty of good faith between the spouses. SDCL 55-17-10 and 55-17-11. Assets designated as special spousal property, or community property, will lose separate property status in the event of divorce.

D. RISK CONSIDERATIONS

As with other tax planning strategies, the risk of IRS challenge is present with the SSPT. The IRS has not commented or ruled on the SSPT or Community Property Trust technique as a means of achieving a 100% stepped up cost basis on the first spouse's death. The IRS has recognized that state law defines what property is and the characteristics of marital property. This principle, coupled with the fundamental concept that states are laboratories of democracy, suggest strongly that the IRS will not find offense with the SSPT strategy. Supreme Court Justice Louis Brandeis, *New State Ice Co. v. Liebmann*, 285 US 262 (US 1932).

The Community Property Trust concept has been codified in other states since 1998 when Alaska first enacted its statutory regime authorizing designated community property. Tennessee passed its Community Property Trust statute in 2010. The IRS has not challenged trusts formed under either state's law in any reported decision or ruling.

Even though results cannot be guaranteed, it appears the downside of a successful IRS challenge is that only one-half of the assets in a SSPT would receive a stepped up cost basis on the first spouse's passing, as is the current rule for jointly owned property in a common law state. Except for the transaction cost of establishing the SSPT and defending a challenge, it appears the couple would be no worse off than if they did nothing in the event of a successful IRS challenge.

Community property by designation merits close consideration by couples with low cost basis assets. Careful consideration should be given to the risks of the strategy and the terms of the SSPT. Only after a couple is satisfied they have made an informed decision should the SSPT strategy be employed.

VII. A TRUST SANS BENEFICIARIES - A NON-CHARITABLE PURPOSE TRUST (AKA THE UBIQUITIOUS PET TRUST)

South Dakota specifically authorizes the formation of a trust with a non-charitable purposes that has no beneficiary. Thus, the grantor can form a trust for the benefit of something as opposed to someone. For example, a grantor can form the ubiquitous pet trust, maintain family heirlooms and vacation homes, deal with IP and digital assets and any number of other purposes. SDCL 55-1-20 thru 55-1-22. Evidently, Minnesota is the only state that does not authorize pet trusts.

Further, a grantor can form a trust that resembles the Zuckerberg hybrid LLC for charitable purposes without adhering to the rules associated with maintaining tax exempt status as a private foundation or a public charity. Note that such a trust would not qualify for tax exempt status.

It is recommended the grantor of a SD Purpose Trust with no beneficiaries appoint a trust protector with powers to enforce the purpose of the trust, receive trust accountings and amend the purpose of the trust in the event circumstances change.

VIII. CONVERSION OF AN INCOME TRUST TO A TOTAL RETURN UNITRUST

SDCL Chap. 55-15 allows a trustee to convert an income trust to a unitrust in order to balance the interests of the current income beneficiary with the remainder beneficiary. A trustee can convert a unitrust to an income trust and change the percentage of the unitrust.

IX. USE OF SOUTH DAKOTA TRUSTS FOR INTERNATIONAL PLANNING

South Dakota has become increasingly popular as a destination for international families seeking to utilize a variety of trust options. The options include (i) SD sitused Foreign Grantor Trust, (ii) Non-Resident Alien Trust, (iii) Stand-by Trust, (iv) Immigration Trust and (v) Qualified Domestic Trust. Such trusts may also incorporate Dynasty Trust and asset protection features.

X. USE OF SOUTH DAKOTA TRUSTS FOR STATE INCOME TAX PLANNING

South Dakota does not have a state income, estate or inheritance tax. Trusts that are administered in South Dakota may protect the income generated by trust assets and the capital gain associated with the liquidation of trust assets from exposure to state income tax, even if the grantor or beneficiaries reside in another state. One category of trusts that accomplish state income tax planning objectives is popularly known as the "ING Trust" – the Incomplete Non-Grantor Trust. An ING Trust sitused in Delaware is referred to as a DING. If a trust sitused in Nevada is used it is referred to as a NING; Alaska is an AKING; and, our personal favorite, is the trust sitused in South Dakota, which is referred to as a "SD-ING."

Existing trusts that are administered in states with an income tax may be moved to South Dakota to escape exposure to income tax. Of course, the home state tax rules must be analyzed to determine whether a trust has sufficient nexus with the home state to expose the trust to state taxes and what is necessary to break the nexus. Several recent court decisions have provided the framework for the analysis of a trust's exposure to state tax and a road map for protecting a trust from state income tax erosion. ***Fielding v. Commissioner of Revenue***, MN SCT No. A17-117, July 28, 2018; ***Kimberley Rice Kastner 1992 Family Trust v. North Carolina Department of Revenue***, No. 307PA15-2 (June 8, 2018); ***Linn v. Department of Revenue***, 2013 IL. App (4^{th}) 121055 (Ill. App. Ct. 4^{th} Dist. 2013); ***Neil Trusts v. Pennsylvania***, 2013 Pa. Comm. Lexis 168 (PA Commonwealth, May 24, 2013); *See Also,* "How ING Trusts Can Offset Adverse Effects of Tax Law: Part I." *Trust & Estates,* September 2018, p. 26.