South Dakota Trust Law: Pulling Back the Curtain
A Soup to Nuts Tour of South Dakota Trust Law
by Patrick Goetzinger and Heath R. Oberloh

43rd Annual Minnesota Probate & Trust Law Section Conference

June 12, 2017
From Soup to Nuts, is a 1928 short comedy film starring Laurel and Hardy as butlers hired for a high society dinner party.
South Dakota’s Fiscal Soundness

- Constitutional requirement to balance budget
- Healthy surplus in General Fund
- Best Bond Rating
- A top performing State Retirement Fund
- Constitutional prohibition on inheritance & estate taxes
...ATTRACTS CAPITAL

- SD Consistently ranked among best places to live & conduct business
- SD leads the nation in total bank assets w/ $2.9 Trillion
- #2 = DE w/ $980B
- #3 = NY w/ $934B
Deep Affection for South Dakota Among Trust Clients & Advisors

<table>
<thead>
<tr>
<th>YEAR</th>
<th># OF STATE CHARTERED TRUST COMPANIES</th>
<th>ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>LESS THAN 5</td>
<td>LESS THAN $1 BILLION</td>
</tr>
<tr>
<td>1996</td>
<td>LESS THAN 5</td>
<td>$12.7 BILLION</td>
</tr>
<tr>
<td>2001</td>
<td>13</td>
<td>$12.7 BILLION</td>
</tr>
<tr>
<td>2011</td>
<td>55</td>
<td>$104 BILLION</td>
</tr>
<tr>
<td>2016</td>
<td>89</td>
<td>$226 Billion (as of 2015)</td>
</tr>
</tbody>
</table>

(Numbers do not include banks)
Why SD is the #1 Ranked Trust Jurisdiction

- Trust Task Force
- Active Attention to Trust Statutes
  - No RAP since 1983
  - Tax Oasis
  - Premium Trust Statutes
- Positive Business Environment

State by state comparison in January 2016 *Trusts and Estates* “Which Situs is Best?” Article
Why put your trust in South Dakota?

• Because you can efficiently & effectively.
• As told by the *fedgazzette*, April 2013,
  • “South Dakota has become a trust company magnet because it has
    configured an attractive regulatory environment for trusts…”
• South Dakota has maintained it’s advantage through the constant attention of the Trust
  Task Force & the annual legislative package that keeps South Dakota at the forefront of
  innovation in an ever evolving trust and economic environment.
Grantor Sovereignty - The Lynch Pin

• “She who has the gold makes the rules.”
• Assures trust terms reflecting the grantor’s wishes will be respected
• Protection from creditors, predators, in-laws & outlaws
• Contrast with statutory regimes that favor beneficiaries
• Statutory authority: SDCL 55-4-30; 55-5-12; 55-1B-1.1; 55-1-53
CONFIDENTIALITY & PRIVACY

• **RESPECTED & PROTECTED UNDER SD LAW W/ ROBUST STATUTES**
• Legal proceedings sealed, but open to interested parties
• Limit beneficiary rights to information
• Balanced Rules, NOT nefarious secrecy:
  ➢ Aggregate AUM & bank franchise tax paid is public information
  ➢ T/C subject to rigorous application process & background checks
  ➢ Trust Companies are audited by SD DOB
  ➢ T/C must have SD presence and deep connections to SD
  ➢ T/C subject to: know your customer rules; FBARs; SARs; SOS disclosures
  ➢ SD is far away from Panama and is NOT Wyoming or Nevada
South Dakota Situs Rules

- How to achieve application of SD law by establishing SD situs

- The North Star

- Well Established & Clear Rules on Applying SD Trust Law to a Trust
  - The Road Map: SDCL 55-3-39 thru 44 & 55-3-48
    - Trust assets located in South Dakota
    - Qualified Trustee per SDCL 55-3-41
    - Trust Administration in SD (Per SDCL 51A-6A-11.1& ARSD)
  - Migrating old trusts to SD: Pitching & Receiving concepts
The SD Trust Rush

• Has its roots in the Dynasty Trust (AKA Perpetuities Trust)
• A Trust w/ unlimited duration
• BEWARE the Unconstitutional Perpetuities Trust Argument
  - 2014 Vanderbilt Law Review Article compared state law w/ state constitution
  - NOT: Nevada, Wyoming, AZ, TN, NC
  - HOT: SOUTH DAKOTA, NH, DE
• Not only another trust planning option, but an illustration of which states do it right
Spendthrift & Third Party Discretionary Support Rules

• A super charged Spendthrift Trust
• Finding protection against creditors in a trust lacking precise spendthrift $
• Statutory preclusion to the judicial application of:
  – The Restatement of Trusts (Third)
  – Uniform Trust Code
  – Which are both decidedly pro-creditor
• Distinguishing Distribution Interests → the Trustee’s Discretion
  – Mandatory
  – Support
  – Discretionary
Is it Possible...

- For a Grantor to form a Trust?
- Transfer assets she owns to the trust
- Name herself as a beneficiary
- Receive an income stream from the Trust
- Protect the Trust assets from the Grantor’s creditors, and
- Do all this without going to jail?
Domestic Asset Protection Trusts (DAPTS)

- A Revolutionary Concept in Camouflage (Since 2005)
- Alaska-1st state in 1997

- AKA Self Settled Trust
- Distinguish from a Third Party Discretionary Trust with Spendthrift $
- Statutory $ → Qualified Dispositions in Trust
- Hybrid DAPT – Trust Protector has discretion to add grantor later
- Estate Exclusion DAPT – Remove assets from estate of grantor
- Requires spousal consent before transferring assets to a DAPT
What was Previously Only Available Offshore

A creature of State Law Chapter SDCL 55-16

BEWARE: UVTA

SD Response: Strong public policy & conflict of laws statutes to assure SD law applies to DAPT
Special Spousal Property Trust
Virtual Community Property Designation for Select Assets

• South Dakota Version of the Community Property Trust
  • Joins Alaska and Tennessee in authorizing such trusts
  • South Dakota is NOT a community property state
• Community Property assets receive a 100% stepped up cost basis upon the death of the first spouse
• South Dakota law authorizes married couples 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 trust assets upon the death of the first spouse
Target highly appreciated assets:

- Marketable securities portfolio
- Tangible Personal Property
- Real Estate
- Closely Held Business Interests
- Couples from a C/P state can now use a South Dakota trust and find it C/P assets without giving up the advantages of a C/P

Multiple Options on Structuring a SSPT:

- Irrevocable or Revocable
- Use within a Revocable Living Trust
- Use with Trust Holding Non-community Property Assets
  - Record keeping
- Pair with a Domestic Asset Protection Trust
- Pair with a Legacy Trust
- Modify or reform an existing trust to add SSPT features
- Decant old trust to new trust with SSPT features
Special Spousal Property Trust
Virtual Community Property Designation for Select Assets

Risks:
- Untested
- IRS silent on tax treatment of such trusts… for 17 years and counting…

Financial Risk:
- Transaction costs and costs of defense if challenged.
South Dakota Dynamic Duo

A South Dakota Paired-up with a SD Limited Liability Entity

- LLE → LLC or LLP
- The LLE owns the assets
- The South Dakota Trust is the member of the South Dakota LLE
  - Single Member LLC Option
- For maximum control the LLE is a manager managed LLC with the family member the manager (or GP if an LLLP is Selected)
- Organizer Sovereignty
  - She who has the gold makes the rules
  - Freedom of Contract is expressly stated in state law
- Asset Protection = BEST IN THE NATION
- Changing Order Rules
  - Sole & Executive remedy of a member’s Judgement Creditor
  - Does not Permit foreclosure of a members interest
  - Denies creditor legal & equitable remedies
  - Prevents court form issuing broad charging orders
Delegated Trusts

- Trustee delegates some of its duties to a third party, such as family member
- Trustee remains liable for actions of person to whom responsibilities are delegated

Special Trustees

- Designated Trustee duties are specifically given to a third party
- Trust document may attempt to minimize liability to Trustee for actions of “special trustee”
- State law may trump trust protections and impose liability upon Trustee for actions of special trustee
Directed Trusts

• Trustee duties are divided up among multiple parties: typically administrative duties, investment duties and distribution duties

• Investment Advisers are given all authority over decisions relating to the investment of trust assets

• Distribution Advisers are given all authority over decisions relating to the distribution of trust assets to beneficiaries

• With respect to investment duties and distribution duties, Administrative Trustee can act only upon being directed to do so by the Investment Adviser or Distribution Adviser
Directed Trusts

- Administrative Trustee is responsible for custody of trust assets, preparing statements, arranging for or supervising tax filings and related administrative functions

- Investment Adviser and Distribution Adviser serve in a fiduciary capacity

- Refer to administrative trustee as “excluded fiduciary.”

- In some states, excluded fiduciary is still liable for gross negligence, however, a South Dakota excluded fiduciary is not liable for actions resulting from following directions from Investment Adviser or Distribution adviser
Directed Trusts

- Henry and Em create irrevocable trust for Dorothy and appoint South Dakota trust company as administrative trustee. Henry and Em are appointed as investment advisers and Dorothy is named as distribution adviser, such to removal and replacement power of Henry and Em.

- Trust owns single member LLC, which LLC holds Kansas farm ground and interests in a tin manufacturing business

- Henry and Em are managers of the LLC. Operating Agreement provides that Dorothy becomes successor manager upon the death of Henry and Em. Dorothy has power to appoint successor manager.
Trust Protectors

- South Dakota was first state to authorize trust protectors in 1997
- Protectors are typically given the power to make changes to an irrevocable trust in order to carry out the grantor’s intent.
- Powers given the trust protector are as defined in the trust instrument
Trust Protectors

- Typical powers include:
  - Appoint a successor trust protector;
  - appoint, add, or remove a trustee;
  - remove and replace a trust advisor, including investment trust advisers or distribution trust advisers;
  - change the trust’s governing or administrative law;
  - change the trust’s situs;
  - alter the interests of trust beneficiaries;
  - interpret the terms of the trust instrument;
Trust Protectors

- Typical powers continued:
  - interpret the terms of the trust instrument;
  - advise the trustee with respect to beneficiaries;
  - approve the trustee’s accountings;
  - amend the trust (can be for any purposes or can be limited to achieve favorable tax status or to respond to changes in the tax code, state law or applicable rules and regulations);
  - add beneficiaries (from designated class of individuals or charities)
  - remove beneficiaries
  - Grant or restrict powers of appointment
  - terminate the trust
Trust Protectors

• Is a trust protector a fiduciary or not?

• Many state laws are not clear and many trusts do not specify

• Can lead to unintended liability for the trust protector, such as *McLean* decision in Missouri which held trust protector liable for bad acts of trustee

• South Dakota provides role is non-fiduciary unless protector is exercising authority of investment adviser or distribution adviser

• Make it clear in the document!
Special Purpose Entities

• Typically, individuals are appointed as Trust Advisers. Entities serving in those capacities are subject to regulation by state Division of Banking

• Some individuals may not be willing to assume liability and O&E insurance may be difficult to secure.

• Loss of continuity if named individuals die or become incapacitated
South Dakota's Directed Trusts

Special Purpose Entities

- South Dakota allows an entity to serve as a Trust Adviser if:
  
  - It is established exclusively to serve as trust adviser or trust protector and its governing documents limit its purpose to those activities;
  - It acts in that capacity in association with a South Dakota trust company or bank;
  - It does not engage in or hold itself out as engaging in trust services;
  - It performs those services only for a specifically named trust or family of trusts;
  - It provides a copy of its annual report to the Division of Banking and agrees to be subject to examination by the Division of Banking
Special Purpose Entities

• Often owned by a purpose trust

• Governing documents can provide for management succession

• Entity can purchase O&E insurance

• Use of special purpose entity offers additional situs connections to South Dakota
Family Advisers

- Provide advice or consultation to trustee or trust adviser
- Serves in a non-fiduciary capacity
- Useful in closely held businesses or farm contexts where family will need operational or management assistance upon death of client
Remodeling a Trust in South Dakota – Non-Judicial Settlement Agreements

• All beneficiaries can agree to modify trust so long as the change will not prevent the trust from fulfilling a material purpose

• Trust can be modified upon consent of settlor and all beneficiaries even if that change is inconsistent with a material purpose

• Be cognizant of estate/gift tax consequences of settlement agreement
Remodeling a Trust in South Dakota – Judicial Reformation

• Can be used to affirm/approve a settlement agreement

• Can also be used where consents or beneficiaries can’t be obtained, or do not want beneficiaries to consent, either for asset protection or transfer tax purposes
  • In those cases, can have beneficiaries waive notice and waive hearing

• Can also seek reformation where not all beneficiaries consent or waive notice
  • Reformation can still be approved if the modification will not significantly impair or adversely affect the rights of the non-consenting beneficiaries
Remodeling a Trust in South Dakota – Judicial Reformation

• Reformations are specifically authorized if the modification would further the settlor’s purposes due to change in circumstances not anticipated, if there was a mistake of fact or law, or if the trust is no longer efficient to operate.

• Trust reformations in SD can be accomplished without a hearing if all parties consent and waive hearing.

• Trust, including reformations, are automatically sealed from public view. Only the settlor, beneficiaries, any fiduciary and their attorneys will have access to the court record without a court order.
Remodeling a Trust in South Dakota – Decanting

• Decanting is an exercise of the trustee’s power to distribute trust assets to a beneficiary. Rather than distribute to the beneficiary, the trustee exercises that authority to distribute the trust assets to the beneficiary in further trust.

• Decanting is authorized by statute in about half of the states.

• Decanting rules vary widely from state to state.

• South Dakota’s decanting statute has been ranked as the top in the nation.
Remodeling a Trust in South Dakota – Decanting

- Trustee must make determination that decanting is necessary or desirable after taking into account the purposes of the existing trust, the terms and conditions of the new trust and the consequences of the distribution.

- Beneficiaries of new trust can only be beneficiaries of the existing trust – can’t add beneficiaries through decanting process

- Can remove beneficiaries

- Can change the interest of beneficiaries, in other words, contingent or remainder beneficiaries of existing trust can become current beneficiaries of the new trust
Remodeling a Trust in South Dakota – Decanting

• Can’t reduce income interest in a QTIP, CRT or GRAT

• “Restricted Trustee”: (i) beneficiary; (ii) trustee that can be removed by a beneficiary if that beneficiary can replace with someone that is related or subordinate to the beneficiary

• Restricted Trustee can’t provide additional benefits or distributions to self unless existing trust is subject to ascertainable standard and can’t use decanting to remove ascertainable standard

• Restricted Trustee can decant to provide better asset protection
Remodeling a Trust in South Dakota – Decanting

• Notice to beneficiaries is NOT required, although is often obtained

• Beware income and transfer tax consequences of decanting:
  • Is the transfer subject to income taxation?
  • If beneficiaries consent, have they made a taxable gift?
  • If a beneficiary’s interest is reduced, has the beneficiary made a gift?

• Use caution when attempting to extend the term of the trust or the vesting of any beneficial interest
Remodeling a Trust in South Dakota – Trust Protector

- If trust protector is appointed in the trust, and amendment powers were granted, trust protector can exercise those powers to amend the trust.

- If no trust protector is appointed, and none of the other options for remodeling are desired, can use one of the other options to amend the trust to appoint a trust protector, grant the trust protector broad amendment powers, such as power to add beneficiaries from a described class.
Questions?

Heath Oberloh  
Lindquist & Vennum, LLP  
101 S. Reid Ste., Ste. 302  
Sioux Falls, SD 57103  
(605) 978-5203  
hoberloh@lindquist.com

Pat Goetzinger  
Gunderson, Palmer, Nelson & Ashmore, LLP  
506 Sixth St.  
Rapid City, SD 57701  
(605) 342-1078  
Patrick@gpna.com