SOUTH DAKOTA
Advantage

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In 1997, the governor of South Dakota created the Governor's Task Force on Trust Administration Review and Reform. This Task Force was commissioned to help South Dakota become the premier trust jurisdiction in the nation. Members of the Task Force have worked to create estate planning and trust administration laws that are cutting edge and consistent such that each statute works with existing law to create a comprehensive scheme of grantor sovereignty, asset and creditor protection, superior privacy, and tax liability limitations. The Task Force has indeed carried out its original purpose, and South Dakota now offers the most advantageous laws in the country, and arguably the world, for those who choose to situs their trusts within its borders.

Grantor Sovereignty

More so than any other jurisdiction, and especially over those in the Midwest, South Dakota offers ways to allow grantors to not only control assets placed in trusts for the benefit of others, but also to continue to benefit from those trust assets while avoiding the liability and tax consequences of direct ownership.

Dynasty Trusts — The True Beginning of South Dakota's Reign Over the Trust Industry

Dynasty Trusts are trusts with perpetual existence. Many states are prevented from offering dynasty trusts due to their existing Rule Against Perpetuities, which limits the time period a deceased person may retain control over his or her assets after death. In 1983 South Dakota became the first state to abolish its Rule Against Perpetuities, which opened the door for grantors to retain perpetual control over assets by keeping them held in trust forever. In states with an existing Rule Against Perpetuities, these types of trusts would either be invalid from the start, or they would expire after the applicable period lapsed, forcing the trustee to distribute the assets held in the trust. In South Dakota, there is no time limit, so a trustee of a dynasty trust will never be forced to distribute assets to a beneficiary due to time expiration.

This permits South Dakota grantors to retain control over trust assets forever — or at least until a court decides that the burden of administering the trust outweighs the benefit for existing beneficiaries. Until then, grantors can use the dynasty trust statute to provide the gift that keeps on giving.

In any case, South Dakota paved the way for other jurisdictions to permit grantors to perpetually control their assets. The combination of the creditor protection provided for beneficiaries of such trusts, the asset protection provided for the grantors of such trusts, and the flexibility to decant these trusts, make South Dakota's dynasty trust statute the most comprehensive and highest ranked in the country.[1] Other states that offer dynasty trusts have either a time limit, decreased creditor protection, weaker asset protection, or less flexibility to distribute trust assets into a trust with more favorable terms.

Directed Trusts — The Epidemy of Grantor Sovereignty

In some situations, a grantor's wishes may be curbed by the traditional trust structure in which the grantor chooses a trustee who is responsible for holding and managing trust assets, prudently investing those assets, making distributions to beneficiaries, and carrying out the administrative duties of the trust (keeping records, filing tax returns, etc.). But sometimes a grantor may wish to remain involved in investment and distribution decisions without having to worry about the administrative duties. Alternatively, a grantor may wish for someone to serve as a trustee, but that person may be unwilling to serve in that capacity due to the accompanying fiduciary liability associated with serving as a trustee.

South Dakota and a few other states have legislated a different option called a directed trust. Directed trusts trifurcate the trustee responsibilities between an administrative trustee, an investment committee, and a distribution committee. By dividing the traditional responsibilities three ways, each party's potential liability is reduced, and the administrative burden is lessened.

While the extent to which the liability and burden on the administrative trustee is decreased varies among states who have implemented the use of directed trusts, South Dakota provides the clearest reduction by relieving the administrative trustee of obligations to perform an investment review and make recommendations. The administrative trustee is no longer responsible to invest the trust assets in a prudent manner because that becomes the investment committee's job. Furthermore, the administrative trustee is not responsible for overseeing or overruling the investment committee's investment decisions, as long as they are consistent with the directions given in the trust instrument (and most trust instruments provide broad investment language).

Similarly, the distribution committee directs the administrative trustee as to when it should make distributions and how much. Again, the administrative trustee is not burdened with overseeing the distribution process, as long as the distributions are consistent with the direction provided in the trust instrument. If a jaded beneficiary later sues the trustee for making imprudent distributions, liability would fall solely on the distribution committee, and the administrative trustee would be off the hook.

While the investment committee directs the administrative trustee about asset placement, and the distribution committee directs the administrative trustee as to

[1] *See* Steve Oshins, *Sixth Annual Dynasty Trust State Rankings Chart* (2018), https://docs.wixstatic.com/ugd/b211fb_5ba497da4c374872be424209eaf7ca7b.pdf.

timing and amount of distributions, the administrative trustee, then, is required to follow the committees' directions to the extent those directions do not conflict with the trust instrument. In this way, the administrative trustee's role is substantially simplified compared to the traditional trustee. Due to this simplification, the fees associated with the administrative trustee are also less than that of a traditional trustee.

This model not only reduces trustee fees, but it also grants to those sophisticated families who wish to manage their own assets greater flexibility in investment decisions. A directed trust provides this flexibility by allowing the grantor, as a member of the investment committee, to direct and control the trustee in investment decisions. The grantor, rather than the trustee, chooses investment strategies and opportunities that conform with the grantor's preferred balance between risk and return. If that preferred balance shifts, the grantor has power to direct the trustee to change the investments accordingly.

South Dakota also provides options for protecting committee members from liability through creating a special purpose entity and by helping committees act on a more informed basis through the use of a trust protector or family advisor.

Liability Protection Through Special Purpose Entities

Even with the reduced responsibilities for those chosen to serve as members of an investment or distribution committee, individuals may feel they are not qualified to measure up to even the reduced fiduciary standards associated with serving in those capacities. Even the financially literate or the investment savvy relative may wish to avoid serving as a trustee or committee member because of the potential liability involved with making those decisions.

The most significant way to shield committee members and other directed trust appointees from liability is by placing them in a South Dakota Special Purpose Entity ("SPE"). This places a liability umbrella over the individuals in the SPE. Investment and distribution committee members, trust protectors, and family advisors may all be placed in a SPE to protect them from personal claims connected to their actions in their separate capacities.

This liability shield stems from liability protection provided for entities such as a limited liability company ("LLC") or a corporation. Because LLC formation and operation is simpler and more flexible than that of a corporation, LLCs are the preferred entity for use as a SPE. LLCs also offer more privacy than a corporate structure. Most importantly, under South Dakota law, the exclusive remedy for a judgment creditor of an LLC is the individual members' contribution to the entity. So when the LLC is sued, the judgment creditor is limited to collecting the assets held by the LLC. Conversely, South Dakota law also provides that when an individual member is personally sued, that individual's interest in the LLC is off limits to a judgment creditor. South Dakota courts have interpreted this law broadly in favor of protecting the entity and its members from creditor liability.

Other states, however, are far less forgiving when it comes to LLC member liability. This is concerning for South Dakota SPEs because, given the nature of directed trusts in which SPEs are used, there are more people involved than under a traditional model in which the trustee fills all roles. With more people come more jurisdictions. If someone messes up, who is liable, and which state's statutes and court decisions apply?

By organizing a SPE LLC in South Dakota, the LLC members (the settlor and investment/distribution committee members) are brought under one roof in South Dakota, nearly eliminating the potential for another state to effectively claim jurisdiction over the LLC or its members. Not only does this shield the individuals from liability associated with their duties as advisors, but it also bolsters the situs of the directed trust in South Dakota, ensuring that South Dakota's advantageous laws apply over another state. This is important to ensure the trust yields as little tax liability as possible (South Dakota has no state income tax or inheritance tax) and to protect the trust's assets from outside creditors of the settlor and beneficiaries (South Dakota offers favorable asset protection laws, discussed below).

Other Key Players — Trust Protectors and Family Advisors

South Dakota's directed trust model, combined with its asset protection laws (discussed later), allow grantors to take advantage of the tax savings and creditor protection offered by an irrevocable trust while still allowing them a high degree of control and benefit from the irrevocable trust's assets. This level of control may be further increased, while still preserving the legal separation required to maintain asset protection, through the use of trust protectors and family advisors.

Trust Protectors

The South Dakota Trust Protector Statute (SDCL § 55-1B-6) provides 18 different powers to trust protectors, as long as those powers are granted in the trust instrument. Most notably, these powers include the ability to modify the trust instrument to deal with both factual and legal changes in circumstance; to increase or decrease any of the beneficiaries' interests; to remove and appoint a trustee, trust advisor, investment or distribution committee member, or any other fiduciary provided for in the trust instrument; to terminate the trust; to veto or direct trust distributions; and to appoint a successor trust protector.

With so much power and discretion, a trust protector should be someone the grantor trusts to know and carry out the grantor's wishes. If the trust protector determines any of the other fiduciaries (committee members, trustee, etc.) is acting contrary to the grantor's wishes, the trust protector can remove and replace the fiduciary in the trust protector's sole discretion, the only limitation being that it act in the best interests of the trust (i.e. the beneficiaries). Whether this creates a fiduciary duty on the trust protector depends on the trust instrument and what action the trust protector engaged in. Trust protectors are deemed to act in a non-fiduciary capacity unless performing the functions of an investment or distribution advisor.

Family Advisors

A family advisor is sometimes permitted to perform certain functions that a trust protector is also permitted to engage in, but does not hold the fiduciary status. The family advisor's permitted powers are set out in SDCL § 55-1B-12, which lists 4 specific powers that may be included in a trust instrument: (1) power to remove and appoint a trustee or other fiduciary provided for in the trust instrument; (2) power to appoint a successor trust protector or family advisor; (3) power to advise the trustee and participate in and consult on trustee and investment/distribution committee meetings; and (4) power to provide direction regarding notification of qualified beneficiaries.

The family advisor role is meant to allow a trusted planning professional, such as a CPA, attorney, or financial advisor, to be involved with important aspects of trust administration without being held to a fiduciary standard. It encourages continuity of direction through generations by protecting the existing planning professional from liability. While the family advisor may be permitted to remove and replace fiduciaries, its main purpose is to provide advice to them.

When used in conjunction with a trust protector, a family advisor can remove and replace the trust protector if it feels the trust protector is no longer carrying out the grantor's wishes or acting in the best interests of the beneficiaries. What's more, the family advisor can take these types of actions without opening him-or-herself up to liability to the beneficiaries.

These two statutory measures allow grantors a great deal of control over assets placed in an irrevocable trust, as long as (1) they provide for these roles and powers in the trust document, and (2) they grant these powers to someone they trust will carry out the grantors' wishes.

Decanting — The Balance of Control and Flexibility for the Future

As time goes on, the future yields the unforeseen. Changes in circumstances inevitably occur which were not initially contemplated by the grantor or accounted for in the trust instrument. These may include a beneficiary moving to another state, family discord, or a change in laws that upset the administration of the trust.

When this occurs, different states offer different solutions. Every state allows judicial modification of a trust, whether by statute or by common law, which requires a court order to modify the terms of the trust document. But standards for when judicial modification is appropriate vary between jurisdictions. In South Dakota, judicial modification is quick and inexpensive if no one objects to the modification.

Many states also offer modification by consent. Again, different states have different standards for when this is allowed and who must give consent. In South Dakota, an irrevocable trust may be modified if all the beneficiaries consent to the modification unless the trust must continue under its existing terms in order to carry out a material purpose of the grantor. If, however, all beneficiaries and the grantor consent to the modification, then modification is permitted regardless of whether modification would be contrary to the grantor's original purpose. If one of the beneficiaries is unable or unwilling to consent to the modification, then judicial modification must be sought.

Finally, a few states offer an easier and more sure solution—decanting. Decanting is the act of the trustee transferring trust assets into a new trust with different, more favorable terms (i.e. terms that account for the new status quo). It also serves as an efficient way to transfer a trust from one state's jurisdiction to another, if needed. Decanting is performed by a trustee, and no consent is required from the grantor, the beneficiaries, or the court. But each state's decanting statute is different, and different requirements must be met in order for a trustee to exercise this power. For instance, many states that offer decanting require the trustee to provide notice to trust beneficiaries of the change. But South Dakota has no such requirement, although it authorizes notice if the trustee chooses to provide it.

South Dakota's decanting statute is found in SDCL § 55-2-15 through -21. For a trust governed under the laws of another state to take advantage of South Dakota's decanting statute, the existing trustee must name a South Dakota trustee so that the trust is administered in South Dakota. Then the South Dakota trustee may decant if the statutory requirements are met. In order to decant, the original trust instrument must give the trustee discretionary authority over distributions. South Dakota's decanting statute allows a trustee to distribute trust assets into a new trust with different beneficiaries under certain circumstances. The primary beneficiaries of the new trust must be someone named in the first trust as a primary, remainder, or contingent beneficiary, or an entity authorized to receive distributions on their behalf. One common use of South Dakota's decanting statute is to accelerate a remainder beneficiary's interest.

While South Dakota's decanting statute also contains several limitations on a trustee's authority to decant, it consistently ranks among the best decanting statutes in the country and was again named as the best in 2018.[2] These laws provide an efficient and inexpensive option for changing trust terms to fit the unforeseen

[2] *See* Steve Oshins, *5th Annual Trust Decanting State Rankings Chart*, (2018), https://docs.wixstatic.com/ugd/b211fb_e22a41932407481c8d324afe4c6e388a.pdf.

circumstances of trust administration and allow appropriate modification while still carrying out the grantor's wishes.

Asset & Creditor Protection Through Domestic Asset Protection Trusts

One of the biggest reasons people place assets into an irrevocable trust is for asset protection purposes. Asset protection generally means protecting one's assets from the claims of one's creditors, such as a lender, an ex-spouse to whom the grantor may owe alimony/spousal support, or someone who has acquired a judgment against the grantor in court (e.g. the grantor was found responsible for causing a car accident). It's easy for grantors to provide creditor protection for beneficiaries named in the grantor's revocable living trust — it's a matter of using spendthrift language prohibiting the use of the assets to pay creditors' claims, and then giving the trustee complete discretion over distribution of principal (so that the beneficiary has no right to demand a distribution). But if the grantor desires creditor protection for herself, her right to control trust assets and to benefit from the trust will depend on state law. Historically, "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."[3]

A Domestic Asset Protection Trust ("DAPT") is used to protect a grantor's assets from her creditors. Before DAPTs, the only way for a grantor to retain control of her assets while protecting them against creditors was to form the trust under foreign law in certain offshore jurisdictions. But Alaska, then Delaware, then South Dakota and several other states created a statutory block to creditors' reach — DAPTs, which are now authorized in 17 U.S. states.

A DAPT is an irrevocable trust that still affords a large amount of control to the grantor while allowing the grantor to be a beneficiary of the DAPT. Specifically, South Dakota's DAPT statute allows the grantor the following rights of control:

(i) power to veto distributions;
(ii) powers of appointment that allow the grantor to redirect distributions during life and after death;
(iii) power to make distributions of the trust principal under certain circumstances; and
(iv) power to replace trustees and trust advisors under certain circumstances.[4]

[3] Patrick Goetzinger and Heath R. Oberloh, *South Dakota Trust Law: Pulling Back the Curtain—A Soup to Nuts Tour of South Dakota Trust Law*, 43rd Annual Minnesota Probate & Trust Law Section Conference, June 12, 2017 (referencing the Restatement of Trusts (Second), Section 156(2)).
[4] *Id.* at 10.

On the beneficiary side, the statute allows the grantor to retain rights to:

(i) trust income generally, and

(ii) distributions of trust principal under certain circumstances.[5]

While DAPTS do not afford grantors the same level of control as that permitted in a revocable living trust, grantors still have significant powers of control and beneficiary rights. The trade-off is the assets held in the DAPT are off-limits to the grantor's creditors. BUT this advantage cannot be enjoyed until the statute of limitations period for creditors bringing claims against the grantor has passed. South Dakota is tied for the shortest limitation period in the country at just 2 years — so a creditor with a claim against property held in the DAPT must make the claim within two years from the time the grantor transferred that asset to the DAPT, with certain exceptions.

South Dakota's DAPT statute is consistently rated one of the best and most aggressive statutory schemes in the nation in terms of affording debtors the greatest protection against creditors' claims.[6]

Privacy

One sought-after advantage of placing assets into a trust is avoiding the public nature of probate proceedings. Because the trust lives beyond the life of the settlor, the assets held in trust pass outside of probate (a public proceeding), so the trust instrument itself remains private. But depending on state law, the trust document may or may not remain private. After a trust is administered, there are two situations that threaten the privacy of the trust contents.

Quiet Trusts — Privacy from Beneficiaries

First, even though a settlor may wish to keep the contents of the trust private from a beneficiary, most states require trustees to inform a beneficiary of that beneficial interest once the beneficiary becomes an adult. Many wealthy people wish for their heirs or chosen beneficiaries to make a life for themselves before ever having access to or even knowledge of a trust established for their benefit. The settlor may wish for that person to learn independence and hard work rather than relying on this gift.

So how can a settlor keep the trust private from the beneficiary? A few states' trust laws allow the settlor to control what information is revealed to a beneficiary and when it is revealed. Trusts that utilize this benefit are known as quiet trusts. South Dakota has the most comprehensive and flexible quiet trust statute in the U.S.

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[5] S.D.C.L. § 55-16-2(2); for instance, if the person with discretion over distributions was a "qualified person" under the statute, then the grantor may receive distributions of principal without losing the creditor protection.

[6] Steve Oshins, *9th Annual Domestic Asset Protection Trust State Rankings Chart*, (2018), https://docs.wixstatic.com/ugd/b211fb_fc5bce98b8d84985900295a749574ed4.pdf.

because it allows the settlor, the trust protector, and the investment/distribution advisor the power to modify the beneficiary's right to knowledge about the existence of the trust and its contents, whether for increased or decreased rights to information.

Statutory Seals—Automatic and Perpetual Privacy When Courts Are Involved

Second, if the contents of the trust or its administration are litigated, or if the beneficiaries or trustee seeks judicial modification, the once private information may be thrust into the public domain. Settlors, trustees, and beneficiaries may request the court to seal the record and thereby keep the trust contents private. Generally, courts may grant or deny the request on a case-by-case basis. State statute will govern how long the record will remain sealed. For example, if a Delaware court grants the request to seal, then the record will remain private for 3 years before it is made public.

In South Dakota, however, trust information that comes out in court is automatically sealed from the public, and no request is required. Furthermore, that seal is perpetual so that trust information never becomes public. South Dakota is the only state with an automatic and perpetual seal on trust information, making it the best trust privacy jurisdiction in the country.

Tax Savings Tools

Constitutional Prohibition on Inheritance Tax

South Dakota's comprehensive statutory scheme to create the most beneficial trust jurisdiction in the country rests on not only statutory authority, but also on state constitutional grounds. In fact, South Dakota has a constitutional prohibition on inheritance tax. Article XI, Section 15 of the South Dakota Constitution states that "No tax may be levied on any inheritance, and the Legislature may not enact any law imposing such a tax." Compared to surrounding states, Iowa and Nebraska both require an inheritance tax, and Minnesota imposes an estate tax. North Dakota does not currently impose an estate or inheritance tax, but it has no constitutional prohibition from enacting them.

No State Income Tax

Yet even with this constitutional protection, the most significant tax advantage offered by South Dakota is that it does not collect income tax. This fact, combined with all the other trust laws, is what makes South Dakota such an attractive jurisdiction to establish trusts originating from other states.

For South Dakota residents who place assets in a South Dakota trust, not being taxed on the trust income is a given, regardless of whether it's a grantor trust or non-grantor trust. It would make little sense to establish a trust in another state that imposes an income tax on its residents — unless, of course, the grantor simply doesn't like money… But for residents from other states that have enacted a state income tax, grantors may place assets in a non-resident trust (a trust sitused and administered in a jurisdiction other than where the grantor or beneficiaries reside) in South Dakota in order to avoid paying income tax on the trust income. This is possible through either an irrevocable trust or an incomplete non-grantor trust residing in South Dakota, rather than the grantor's state of residence.

In both of these types of trusts, the grantor gives up ownership of the trust income during the grantor's life. So rather than income passing directly through to the grantor (which happens if the trust is a grantor trust, such as a revocable living trust), the income lies with the trust itself. If the trust is a resident of a state where there is no income tax (such as South Dakota), then the income produced by the trust assets is never taxed at the state level.

Incomplete Non-Grantor (ING) Trusts

While general irrevocable trusts can be used to avoid state income tax liability if the trust is a South Dakota resident, they will also result in gift tax consequences (i.e. reduction of the grantor's unified credit and potential federal estate tax liability) and loss of the step-up in basis on the grantor's death. But incomplete non-grantor trusts give grantors the best of both worlds. They avoid gift tax consequences and utilize a step-up in the grantor's tax basis on the grantor's death while still giving up ownership of the trust income during the grantor's life.

In short, incomplete non-grantor trusts combine the benefits of a grantor trust (the step-up in basis and not having to pay gift tax) and a non-grantor trust (income is owned by the trust, not the grantor). So if the trust is a resident of South Dakota, the grantor will pay neither state income tax nor federal gift tax.

This tax planning tool will be most beneficial for out-of-state grantors holding highly appreciated assets that would otherwise be taxed on the income derived from those assets. This will also be highly beneficial for those grantors who wish to retain control over how the trust assets are invested. Such grantors may engage in trading assets, etc., that would normally be a liquidating event subject to state income taxation. But because the assets are owned by the trust in a state without income tax, nothing is subject to state income taxation until a distribution is made from the trust to a beneficiary, if that beneficiary lives in a state that collects income tax.

The IRS has issued Private Letter Rulings supporting this tax-saving technique, and individual states have begun supporting the use of resident trusts to avoid paying income tax in the grantor's state of residence. In *Fielding v. Commissioner of Revenue*

(Minn. 2018), the Minnesota Supreme Court held that the residence of the trust, and its consequential duty to pay income tax in the state of residence, depends on whether the trust, not the grantor, retains a minimum connection with the state. So even if a grantor lives in Minnesota, if the trust is administered elsewhere, and if trust assets don't generate income within the state of Minnesota, then the trust is not a resident of that state sufficient to be taxed therein. For additional analysis of *Fielding v. Commissioner*, see this post on freeing trusts from Minnesota's income tax.

Community Property Trusts

There are nine community property states in the nation. These states offer a significant tax benefit to married couples upon the first spouse's passing. When the first spouse dies, marital assets (rather than separate property) get a 100% step-up in tax basis immediately. By contrast, separate property states only afford a step-up in basis for the portion of marital property deemed to be owned by the deceased spouse. So once the first spouse passes away, only half of the asset gets a step-up in tax basis. Therefore, community property states allow the surviving spouse to take advantage of the full step-up in basis by selling appreciated assets while drastically reducing or even eliminating any income tax liability on the sale. In community property states, the full step-up in basis can be enjoyed by the surviving spouse. In separate property states, the full step-up must wait until the surviving spouse passes, so the benefit is enjoyed by the heirs/beneficiaries.

This disparity between community property states and separate property states caused lawmakers in South Dakota, Alaska, and Tennessee (all separate property states) to provide a way for married couples in separate property states to enjoy this tax benefit. This is possible through a community property trust (or, in South Dakota, a "Special Spousal Trust"). These revocable trusts allow married grantors in separate property states to maintain full control over the asset while still enjoying the tax benefit as though they lived in a community property state. This strategy can also be used in conjunction with South Dakota ING trusts to help out-of-state couples with appreciated assets to accelerate the 100% basis step-up while avoiding paying state income tax.

South Dakota Special Spousal Trusts are a great tool for reducing a surviving spouse's federal tax liability while still alive and without giving up control over or the right to benefit from marital assets. But couples should be careful which assets they place in a Special Spousal Trust because depreciated assets also receive a complete step-down in basis following the first spouse's death. Couples should only designate as community property appreciated assets with steady value and avoid placing volatile, high-risk assets into the trust.

DAPTs Tax Savings — For the 0.1%

For those wishing to make the most of their unified estate/gift tax exemption, gifting assets during life traditionally has more benefit than having those assets included in one's gross taxable estate at death. Gifting during one's life (creating gift tax liability) provides two fundamental advantages over gifting at death (creating estate tax liability). First, "lifetime transfers enable any post transfer appreciation in value and any income generated by the transferred asset to escape transfer taxation."[7] Second, gift taxes for lifetime transfers have a lower effective tax rate than estate taxes because it is imposed only on the value of the property actually received by the donee after the gift tax has been paid (rather than taxing the entire value of the gross estate). The disadvantages of lifetime gifts is the loss of controlling, and benefiting from, the asset.

To take advantage of lifetime giving, the IRS requires that the assets be shielded from the grantor's creditors. If they aren't, the theory is that the grantor can run up debts with no intention of paying them, knowing that the grantor's creditors could satisfy the debt by accessing the trust assets. Therefore, because the grantor retains dominion and control over the assets, the gift is incomplete and is not pulled from the grantor's taxable gross estate.[8]

One way to make a completed gift is to place the asset in an irrevocable trust. But when a grantor retains the right to benefit from an irrevocable trust, traditional law disallows creditor protection for that grantor/beneficiary. If the grantor retained the right to benefit from the trust, creditor protection would be lost, the gift would be incomplete, and the asset would still be included in the grantor's gross taxable estate.

So how does one make a lifetime gift subject to gift tax (and therefore avoiding estate tax) while still retaining the right to benefit from the asset and while shielding the asset from one's creditors? As previously discussed, South Dakota DAPTs make this possible. DAPTs allow grantors to enjoy the tax benefits of completed lifetime gifting (creditor protection and no longer in grantor's gross estate) while continuing to benefit from the gifted asset — to have their cake and eat it too![9]

This requires the grantor to give up any ability to control or name future beneficiaries and distributions. This is done by appointing an independent trustee with sole and absolute discretion over distributions. This removes the grantor's control over

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[7] Mark R. Krogstad and Matthew W. Van Heuvelen, *Domestic Asset Protection Trusts: Examining the Effectiveness of South Dakota Asset Protection Trust Statutes for Removing Assets from a Settlor's Gross Estate*, 61 S.D. L. REV. 378, 389 (2016).

[8] *See* Internal Revenue Code §§ 2036, 2038 (2012). *See also* Treas. Reg. § 25.2511-2(b) (as amended in 1999).

[9] Krogstad and Van Heuvelen, 61 S.D. L. REV. at 390.

requiring the trustee to make distributions.[10] It also requires that the assets in the trust be protected from the grantor's creditors. This requires spendthrift language in the trust, which expressly prohibits a creditor's ability to access trust assets to satisfy obligations owed it by the beneficiary. Spendthrift protection for the grantor is only available in states with statutory schemes allowing for self-settled spendthrift trusts, such as South Dakota's DAPT statute. Because South Dakota's DAPT statute provides such robust creditor protection, creditors have no control over assets transferred to a DAPT. Thus, it is sufficient to make a completed gift under I.R.S. standards, subject to the gift tax, but excluded from the grantor's taxable estate at death.

South Dakota DAPTS, therefore, allow grantors both creditor protection and tax benefits that are unavailable in most other states.

The Tax-Saving Purpose of Dynasty Trusts

Whenever an asset is gifted to someone during life or at death, the grantor's unified credit is reduced by the value of the asset. This also occurs whenever a trust distributes an asset to a beneficiary—the gift is completed at that time, and the grantor's unified credit decreases. But if the trust holds onto that asset, only distributing income and not the principal, then the taxable liquidation event never occurs, and the grantor's unified credit is never reduced by the value of the assets held in trust.

A trust that perpetually holds assets without distributing trust principal is a Dynasty Trust. South Dakota became the first U.S. jurisdiction to offer these trusts in modern times when it abolished by statute its Rule Against Perpetuities (a rule limiting the amount of time a person could retain control over property after death). So a trustee of a Dynasty Trust will never be forced to distribute assets to a beneficiary due to time expiration. Consequently, the grantor's unified credit will never be decreased due to a distribution of trust principal to a beneficiary.

Dynasty Trusts make little sense for most people as time goes by because the income from the trust is spread across an ever-increasing number of beneficiaries. Furthermore, most people shouldn't be concerned about federal estate taxes given its high threshold (only 1 out of every 1,000 estates qualify for federal estate taxes). But for those few who do qualify, a dynasty trust can be an effective tool for giving trust income to multiple generations while avoiding federal estate tax liability. Grantors can provide a gift that keeps on giving without ever paying federal estate taxes on it.

[10] But if an "implied agreement" exists between the grantor and the trustee, then the grantor may retain too much control for the gift to be complete.

Implementing the South Dakota Advantage

The estate planning strategies and advantages discussed throughout this e-book are advanced planning techniques that should only be drafted by a knowledgeable estate planning attorney who understands the tax, creditor protection, and control consequences of each technique. Most attorneys who are highly proficient in other practice areas (such as any number of areas of litigation or even business transactions) will not possess the requisite knowledge to properly implement these South Dakota-specific techniques.

For assistance in exploring whether any of these techniques should be implemented as part of your comprehensive estate plan, contact an estate planning attorney licensed in South Dakota.

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