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SOUTH DAKOTA DOMESTIC ASSET PROTECTION TRUSTS

South Dakota's "Act to Authorize Qualified Dispositions in Trust" allows individuals to create self-settled spendthrift trusts in South Dakota. Self-settled trusts which contain enforceable creditor protections are often referred to as "asset protection trusts" or "domestic asset protection trusts" ("APTs" or "DAPTs" for short). "Self-settled" or "self-funded" means a trust that is created with the trust creator's own assets.

ASSET PROTECTION TRUSTS FOR SOUTH DAKOTANS (AND OTHERS TOO)

The idea of a self-funded trust with creditor protections was first enacted in offshore jurisdictions beginning in the 1980s. These trusts were often venued in exotic locations such as the Bahamas and the Cook Islands. In 2005 South Dakota became a "domestic" jurisdiction which has authorized self-settled spendthrift trusts, and since that time has consistently been rated as the top jurisdiction for such trusts by various sources (e.g., *Trust & Estates* magazine).

To qualify as an APT, the trust must (1) expressly incorporate South Dakota law; (2) have at least one South Dakota trustee; and (3) be irrevocable. There are no limits to the amount of funds or property which can be transferred to a South Dakota APT.

There is no requirement that the grantor of the trust (i.e., the creator of the trust) be a South Dakota resident, nor that any property of the trust be located in our state. Thus, South Dakota APTs have become popular with residents from other states wishing to take advantage of South Dakota's favorable trust laws and state taxation.

The South Dakota Act permits the individual creating the trust to retain the following rights:

- Veto power over distributions;
- Income rights to trust property;
- Rights to 5% of the principal balance of trust property annually;
- Additional rights to principal in the trustee's discretion; and
- The power to appoint to whom trust assets are distributed upon the grantor's death (with certain minor limitations).

Other interesting advantages of South Dakota include:

- The APT can be structured to be in or out of the grantor's estate for federal tax purposes;
- The grantor can be an "investment advisor" for the APT;

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- The grantor can choose the trustee and other fiduciaries / trust advisors (subject to certain limitations); and
- The APT can be structured to be a “grantor trust” or “non-grantor trust” for federal income tax purposes.
 - Note that if the trust is taxed on its own income, South Dakota is a pure no income and no capital gains tax state for trusts.

LIMITATIONS

The South Dakota Act carves out two major exceptions to the creditor protection benefits of an APT:

- ~ Creditors claiming child support, alimony, and divorce decrees of property division are not protected;
- ~ Claims for death, personal injury or property damage caused by the grantor on or before the date the trust is created are not protected; and
- ~ As with all spendthrift trusts, once a distribution is actually made by the trustee and received by the grantor/beneficiary, it becomes an asset which is no longer protected from creditors.

In addition, creditors will sometimes be able to bring a “fraudulent transfer” claim associated with the funding of an APT. However, the South Dakota Act requires creditors to meet a very high burden of proof to do so. If an individual’s financial situation so deteriorates that bankruptcy is triggered, amendments (enacted in 2005) to the Bankruptcy Code provide for a ten year “look back” period for transfers to self-settled trusts if a creditor can prove that the trust was intended to defraud and hinder creditors.¹

There are additional limitations to the protections of a DAPT when state lines are crossed. Self-settled spendthrift trusts are considered to be against “public policy” in some states. Thus, if the trust owns assets in another state, the protections of South Dakota law may not be recognized if a creditor brings an action to satisfy a judgment against assets outside of South Dakota. Protections are at their highest when:

- The Trustee is truly independent of influence or control by the grantor;
- The Trust instrument scrupulously adheres to the requirements of South Dakota law;
- The Trust is funded with assets located in South Dakota;

¹ 11 U.S.C. section 548(e)(1)(A).

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- Any lawsuit arises out of events in South Dakota occurring after the trust was created; and
- If bankruptcy is involved, ten years passes between the funding of the trust and the filing of a bankruptcy petition.

Individuals who are non-residents of South Dakota may avail themselves of the benefits of South Dakota APT statutes. These individuals, however, are at higher risk to sister state jurisdictions who may permit “trust busting” of APTs.²

WHO SHOULD CONSIDER AN APT?

Individuals who should determine if an APT is right for them include:

- Those whose net worth exceeds several hundred thousand dollars;
- Those in higher risk profile professions;
- Those whose assets may be exposed to lawsuits;³
- Those who believe their assets are worth protecting.

ADDITIONAL BELLS AND WHISTLES

Because South Dakota earlier repealed the “Rule Against Perpetuities” that previously prohibited trusts of an infinite duration, some individuals will likely pursue the option of combining the idea of a dynasty trust (which effectively escapes estate taxes at each generation with generation-skipping transfer tax provisions) with an APT. When a DAPT is used in this way, the savings in estate tax is icing on the cake of a solid asset protection strategy.

TRUST ADVISORS

The following is a general description of the role of “Trust Advisors.” The roles generally referred to as Trust Advisors are the Investment Advisor, Investment Manager, Distribution

² See David G. Shaftel and David H. Brundy, *Domestic Asset Protection Trusts and the Bankruptcy Challenge*, 32 ESTATE PLANNING 5, 11 (May 2005).

³ Assets for South Dakota residents which carry a lower risk of seizure – up to certain amounts - include retirement accounts, a homestead, annuity contracts up to \$250 per month and life insurance payable to a spouse/dependents up to \$20,000. Federal law provides different protections. Interests in closely-held entities such as LLCs or corporations are not immune to creditors, but less attractive to creditors because of the limited remedies available. Assets with the highest exposure to risk would include cash, real property and investments.

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Committee, and Trust Protector, although the names of such roles can vary.

- **Investment Advisor(s)**

- The Investment Advisor(s) directs the trustee as to how to invest the trust's assets. This advisor oversees the growth and management of the trust assets.
- The Grantor of an APT could even act as the Investment Advisor.
- Investment Manager.
 - The Investment Advisor may hire one or more Investment Managers. The Investment Manager would then be in charge of the investment of the trust's assets. You can think of the Investment Advisor / Investment Manager relationship much in the same way as you would the relationship between yourself and your financial planner. An Investment Advisor, like you, would be able to direct the investment. However, sometimes the Investment Advisor might hire a financial planner to help actively manage the investments.

- **Distribution Committee**

- The Distribution Committee consists of one or more members who direct the trustee in regard to discretionary distributions to the beneficiary.

- **Trust Protector(s)**

- The Trust Protector has various powers, including the power to appoint, remove, and replace any of the other Trust Advisors, and even the trustee. The Trust Protector is less concerned with the day-to-day administration of the trust, and acts more as an overarching protector, as the name implies. The Trust Protector can have the powers of the other trust advisors.

CREATING AN APT

Flexibility is an exciting component of these trusts, and several different variations and types of trusts will be available to meet various objectives.

The information in this bulletin should not be interpreted as legal advice.

No one legal rule can be applied to all individuals or situations.

General information is provided here. Always consult an attorney for legal consultation.