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The State Bar of South Dakota  
and The Continuing Legal Education Committee

*present*

AN UPDATE ON  
SOUTH DAKOTA  
TRUST LAWS

**Sarah Richardson Larson, Chair**

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Rapid City, South Dakota

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# How to Change Irrevocable Trust In South Dakota

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## HOW TO CHANGE AN IRREVOCABLE TRUST IN SOUTH DAKOTA

1. When would you need to change an irrevocable trust, and why?
  - a. To improve the trust's administrative provisions.
    - i. To replace a corporate trustee with an individual where the document requires a corporate trustee.
    - ii. To clarify or streamline trustee succession.
    - iii. To allow a beneficiary to serve as trustee.
    - iv. To move trust situs to or from another jurisdiction.
    - v. To terminate small trusts.
  - b. To change the governing law if the trust does not allow such a change.
    - i. To take advantage of another state's favorable trust laws.
  - c. To change dispositive provisions.
    - i. To make a distribution not clearly within the standard set forth in the trust.
    - ii. To adjust trustee powers.
    - iii. To adjust restrictions on beneficiaries.
    - iv. To benefit new, unanticipated beneficiaries.
  - d. To modernize or update a trust.
    - i. To divide a trust to separate generation-skipping transfer tax (GST) exempt property from other property.
    - ii. To divide the trust into separate trusts.
    - iii. To consolidate trusts.
    - iv. To adjust trustee compensation provisions.

v. To adjust outdated distribution caps or formulas to account for inflation and cost of living increases.

vi. To adjust antiquated social conventions.

1. For example, to include adopted children or children born out of wedlock as beneficiaries.

e. To achieve tax goals.

i. To qualify for the marital deduction.

ii. To obtain a charitable deduction.

iii. To meet qualified domestic trust (QDOT) requirements.

iv. To allow tax-driven trusts, such as grantor retained annuity trusts (GRATs), to qualify if applicable requirements have been changed by statute or regulation.

f. To correct ambiguous or poorly-drafted documents.

## 2. When and How to Amend

### a. Modification / Reformation

i. SDCL §§ 55-3-23 to 55-3-29 provide the ability to modify an irrevocable trust.

ii. SDCL Ch. 21-22 governs administration of trust estates.

1. Pursuant to SDCL § 21-22-2, SDCL §§ 55-3-24 to 55-3-44, inclusive, apply to all court-supervised actions or proceedings.

iii. By agreement of interested persons.

1. SDCL § 55-3-24 allows an irrevocable trust to “be modified or terminated upon the consent of all the beneficiaries if continuance of the trust on its existing terms is not necessary to carry out a material purpose. Whether or not continuance of the trust on its existing

terms is necessary to carry out a material purpose, an irrevocable trust may be modified or terminated upon the consent of the trustor and all of the beneficiaries.”

## 2. Procedure

- a. The beneficiaries may consent/agree to modification and termination if continuation is not necessary to carry out a material purpose of the trust.
  - i. A written agreement among beneficiaries or written consents to a proposed modification or termination should be obtained.
- b. All interested parties (i.e. the trustee and beneficiaries) may enter into an agreement setting forth the terms of the modification or termination of the trust in other situations.
  - i. A written agreement among all interested parties or written consents to a proposed modification or termination should be obtained – SDCL § 55-3-24.
  - ii. Judicial approval is not required if all interested parties agree/consent and if no interested party is unable to contract or is unable to consent through virtual representation as discussed below – SDCL §§ 55-3-24; 55-3-32 to 55-3-38.
  - iii. Even though court approval may not be required, it may be sought upon the petition of any interested party – SDCL § 55-3-25.
- c. SDCL § 55-3-24 states that if a trust is so terminated, “the trustee shall distribute the trust property in accordance with the trustor’s probable intention or in any other manner as agreed by all the beneficiaries.”

- d. Exercise of power by an agent.
  - i. “The trustor’s powers with respect to termination or modification may be exercised by an agent under a power of attorney only to the extent the power of attorney expressly so authorizes.” Id.
- e. Exercise of power by a conservator.
  - i. “A conservator may exercise the trustor’s powers under this section only if approved by the court supervising the conservatorship.” Id.
- f. Consent by a person under a disability.
  - i. “If the consent of a person under disability is required, such consent may be given by any person upon whom notice may be served pursuant to §55-3-35.” Id.
- g. SDCL § 55-3-35 is a virtual representation statute that allows a party “with the same interest as a person under disability” to receive process as a representative of the class of interests to which the person under disability belongs. If there is no person not under a disability with the same interest as the person under a disability, the person’s conservator, if one has been appointed, may be served. If there is no person with the same interest and no conservator, the natural parents may be served, or if there are no natural parents alive, the adoptive parents may be served. If none of the above applies, the party who has assumed the person’s care and custody may be served. If the person is an adult and there is no conservator, notice may be served on an agent under a durable power of attorney, a guardian, a trustee

of the person's estate, or any person responsible for the adult's care and custody.

h. SDCL § 55-3-27 allows that, “[e]xcept as otherwise provided by terms of the trust, if the value of the trust property of a noncharitable trust is less than fifty thousand dollars, the trustee may terminate the trust.”

i. SDCL § 55-3-27 also allows that termination under this section pursuant to court order, as discussed below.

iv. By court order

1. SDCL § 55-3-25 allows a trustor, trustee, or beneficiary to petition the court to affirm a proposed modification or termination of a trust if the provisions of § 55-3-25 have not been met.
  - a. If a beneficiary does not consent, the court may approve a requested modification or termination if the rights of the non-consenting beneficiaries are “not significantly impaired or adversely affected.” Id.
2. SDCL § 55-3-26 allows a trustee or beneficiary to petition the court to “modify the administrative or dispositive terms of the trust or terminate the trust if, because of circumstances not anticipated by the trustor, modification or termination of the trust would substantially further the trustor's purpose in creating the trust.”
3. SDCL § 55-3-27 allows a trustee or beneficiary to petition the court for modification or termination of a noncharitable trust or appoint a new trustee if the court determines that the value of the trust property is insufficient to justify the cost of administration.
  - a. Under this section, the court must examine whether appointment of a new trustee to continue the trust is feasible.



4. SDCL § 55-3-28 states that “[o]n petition by a trustee or beneficiary, the court may reform the terms of the trust to conform to the trustor’s intention if failure to conform was due to a mistake of law or fact and the trustor’s intent can be established.”
  - a. This section may also be used to achieve favorable tax objectives so long as the trustor’s intent is not defeated.
5. SDCL § 55-3-29 allows a trustee to combine two or more trusts or divide a trust into two or more trusts “if the combination or division does not impair the rights of any of the beneficiaries or substantially affect the accomplishment of the trust purposes.”
  - a. On petition, “the court may affirm or prevent a proposed combination or division; and, if the terms of the trust instruments creating the trusts are inconsistent, the court shall resolve such inconsistencies in its order by establishing the terms of the trust that will survive the combination or division.”
6. SDCL §§ 55-3-23 to 55-3-29 are not the exclusive methods to modify or terminate an irrevocable trust See SDCL § 55-3-30.
7. A trust automatically terminates if its term expires, its purpose is fulfilled, its purpose becomes unlawful or impossible to fulfill, or, in the case of revocable trusts, the trust is revoked – SDCL § 55-3-23.
8. The virtual representation statutes found at SDCL §§ 55-3-32 to 55-3-38 apply in any proceeding where all interested parties are required to be served of where their consent is necessary. SDCL § 55-3-31.
9. Charitable trusts may be modified by court order where “the purpose and object of such charity is imperfectly expressed, or the method of administration is not indicated or is incomplete or imperfect, or

[when] the fulfillment of the special purpose expressed in a trust for charitable or public purpose is or becomes impracticable, impossible, inexpedient or unlawful...” Any trustee, interested party or the state attorney general may petition for an order directing the trust to be administered to “accomplish the general purposes of the instrument and the object and intention of the donor...” if the donor’s consent is obtained if the donor is still living – SDCL § 55-9-4.

- a. The attorney general represents the beneficiaries in all cases arising under SDCL Ch. 55-9, dealing with charitable trusts.

## 10. Procedure

- a. Any trustee or beneficiary may petition for court supervision pursuant to SDCL § 21-22-9.
- b. Interested parties may also petition for the requested modification or for a court order or directions regarding “any matter relevant to the administration of the trust.” SDCL § 21-22-13.
- c. Notice of the petition “shall be served on trustees, beneficiaries, and attorneys of record, either personally or by mail, addressed to each at his or her last known post office address as shown by the records and files in the proceeding, at least fourteen days prior to the hearing unless the court for good cause shown directs a shorter period.” SDCL § 21-22-18.
  - i. The court may allow service by publication (once a week for three weeks prior to the hearing in a legal newspaper in the county of the hearing) if the number or persons to be served and the expense involved would be burdensome. SDCL § 21-22-19.
  - ii. If all beneficiaries join in the petition in writing or waive notice and a hearing in

writing, notice will not be required.  
SDCL § 21-22-21.

- d. Any interested party may object to the petition. If such objections are brought, the court may order them to be filed and may adjourn the hearing and continue it to a contested calendar. SDCL § 21-22-16.
- e. The court may require or allow witnesses or production of evidence. SDCL § 21-22-25.

b. Decanting

i. Decanting involves the idea that a trustee with authority to make discretionary distributions may appoint trust property in further trust instead of making distributions outright.

- 1. A trustee may “decant” trust funds from one trust into a different trust.
- 2. This principle existed at common law but has now been codified in South Dakota and certain other jurisdictions.

- a. South Dakota’s decanting statutes are found at SDCL §§ 55-2-15 to 55-2-21, inclusive.
- b. Other states with decanting provisions include Alaska (Alaska Stat. § 13.36.157), Delaware (12 Del. C. § 3528), Florida (Fla. Stat. § 736.04117), New York (NY EPTL § 10-6-6(b)), and Tennessee (Tenn. Code Ann. § 35-15-816(b)(27)).

ii. Decanting is appropriate where the trustee has discretionary authority and wishes to “pour” funds from one trust to another trust with terms more favorable for current needs.

- 1. SDCL § 55-2-15 allows a trustee with “discretionary authority” to make income and/or principal distributions to a beneficiary to instead exercise that

authority by appointing all or part of the assets subject to that power to the trustee of a second trust.

2. Beneficiaries of the second trust must be either proper objects of the exercise of distribution power, or “one or more of those other beneficiaries of the first trust to or for whom a distribution of income or principal may have been made in the future from the first trust at a time or upon the happening of an event specified under the first trust.” Id. at (1).
  - a. Under this statute, the second trust may, within certain limits, have different beneficiaries.
  - b. For example, contingent beneficiaries of the first trust may be named as primary beneficiaries in the second trust. Id.
3. SDCL § 55-2-15 also requires that the trustee take “into account the purposes of the first trust, the terms and conditions of the second trust, and the consequences of the distribution.”
  - a. The trustee may wish to decant to a second trust to preserve or promote the trustor’s primary purpose in establishing the first trust.
  - b. If more drastic changes are desired, it may be advisable to seek reformation by beneficiary consent or court approval, as discussed above.
4. Tax consequences, as discussed below, should be considered before decanting.
5. As it is authorized by statute, decanting does not require beneficiary consent or court approval.
  - a. However, SDCL § 55-2-18 requires that decanting be done by “an instrument in writing, signed and acknowledged by the trustee and filed with the records of the trust” and that all beneficiaries of the first trust be notified in writing at least 20 days prior to decanting.

Information in the notice must include a copy of the proposed decanting and a copy of the second trust.

- b. SDCL § 55-2-18 further allows that, if all beneficiaries entitled to notice waive notice, the trustee may decant immediately.
  - c. Beneficiaries include anyone entitled to notice and a copy of the first trust. Id.
    - i. See SDCL § 55-2-13.
  - d. South Dakota's virtual representations apply to such notice requirements - SDCL § 55-2-18.
    - i. See SDCL §§ 55-3-31 to 55-3-38, inclusive.
6. Decanting may be applied to testamentary trusts or irrevocable inter-vivos trusts – SDCL § 55-2-15.
  7. Decanting may not result in the reduction of a fixed income interest for which a marital deduction has been taken or to a charitable remainder trust or to a GRAT – SDCL § 55-2-15(a)-(c).
  8. The power cannot be exercised to extend the IRC § 2503(c) vesting period – SDCL § 55-2-15(3).
  9. The power cannot be exercised over any portion of the trust to which a beneficiary has current withdrawal rights (i.e. Crummey rights or 5x5 powers) – SDCL § 55-2-15(5).
  10. The terms of the trust must not prohibit exercise of the authority by a spendthrift clause or provision prohibiting amendment of the trust – SDCL § 55-2-15(6).
  11. SDCL § 55-2-15(2)(a) limits the power to decant unless held to an ascertainable standard if the trustee is also a beneficiary or if any beneficiary of the first trust

has the right to change the trustees of the first trust.  
See discussion of estate inclusion issues, below.

c. Conversion to a Total Return Unitrust

- i. See discussion on separate outline.

d. Exercise of a Power of Appointment

- i. SDCL § 55-1-24(5) defines a “power of appointment” as “an inter-vivos or testamentary power to direct the disposition of trust property, other than a distribution decision by a trustee to a beneficiary. Powers of appointment are held by a person to whom a power has been given, not the [trustor].”

1. See also SDCL 29A-1-201(36): “Power of appointment’ means a power to vest absolute ownership in the property subject to the power, whether or not the powerholder then had capacity to exercise the power. ‘General power of appointment’ means a power exercisable in favor of the powerholder, the powerholder’s estate, the powerholder’s creditors, or the creditors of the powerholder’s estate, whether or not the power is also exercisable in favor of others. “Presently exercisable general power of appointment” includes a power to revoke or invade the principal of a trust or other property arrangement, but excludes a power exercisable only by the powerholder’s will.”

- ii. SDCL § 29A-1-108: “For the purpose of granting consent or approval with regard to the acts or accounts of a personal representative or trustee, and for purposes of consenting to modification or termination of a trust or to deviation from its terms, the sole holder or all co-holders of a presently exercisable general power of appointment are deemed to act for beneficiaries to the extent their interests (as objects, takers in default, or otherwise) are subject to the power.”

3. Tax Consequences

- a. Consider whether the changes will be given effect by the IRS and whether there will be unintended or adverse tax effects.

b. Income taxes

i. Where the property is being sold or exchanged for another asset.

ii. Issues

1. Decanting: Is the new trust the same as the old trust for income tax purposes?
  - a. The new trust's distributable net income (DNI) would be shifted to the new trust, including capital gain – see Reg. 1.643(a)-3(e).
  - b. Decanting may eliminate or create state or local taxation if the trust situs is changed.
  - c. If less than the entire trust corpus is decanted, this may be the equivalent of a discretionary distribution by the trustee.
    - i. Such distribution may carry out DNI to the beneficiary.
  - d. The new trust should obtain its own taxpayer identification number unless it is a grantor trust.
2. Negative basis assets decanted to a new trust may result in recognition of gain pursuant to Crane, 35 AFTR 773, 331 U.S. 1, 91 L.Ed. 1301, 1947-1 C.B. 97 (1947).
  - a. However, IRC 643(e) provides that the fiduciary's basis carries over to the beneficiary, and this may override Crane.
  - b. Trustees may wish to seek a private letter ruling before decanting negative basis assets or may wish to leave such assets in the old trust.
3. Decanting may result in beneficiaries recognizing gain.

- a. Normally beneficiaries only experience income to the extent the distribution carries out DNI – see IRC 662(a).
- b. However, the IRS may contend that a change in the beneficiary’s interest may trigger income, pursuant to Cottage Savings Ass’n, 67 AFTR 2d 91-809, 499 U.S. 544, 113 L.Ed. 2d 593, 1991-2 C.B. 34 (1991).
- c. A change in the beneficiary’s interest from an income interest to a unitrust interest should not recognize gain if the beneficiary’s interest was always subject to conversion in the governing document - see PLR 200810019.

#### 4. Other tax consequences

- a. Conversion of a domestic trust to a foreign trust (or decanting from a domestic trust to a foreign trust) may result in gain recognition under IRC 684; however, there is an exception if the grantor is still living - see IRC 684(b).
- b. The power to add to the class of beneficiaries may cause a non-grantor trust to be treated as a grantor trust.
  - i. When drafting a non-grantor trust, consider adding a provision to bar decanting in a manner that would add to the class of beneficiaries within the meaning of IRC 674.
  - ii. Consider also whether giving a beneficiary a lifetime power of appointment constitutes a power to add to the class of beneficiaries pursuant to IRC 674.

#### c. Gift taxes



- i. Recognized where property is transferred or deemed transferred during lifetime for less than adequate consideration.
- ii. If a beneficiary agrees to or does not object to decanting or a change in the trust that dilutes or forfeits a beneficial interest in the trust, a taxable gift may result.
- iii. The power to decant, if held by a beneficiary (acting as trustee), may result in a taxable gift.
  - 1. Consider giving the beneficiary a limited power of appointment to avoid this result.

d. Estate tax

- i. Recognized where property is transferred at death.
- ii. If decanting results in the beneficiary making a gift, that beneficiary's estate will likely include the decanted trust property if the transfer falls under IRC 2035, 2036, 2037, 2038, 2039, or 2042.
- iii. Even if the beneficiary doing the decanting was given a limited power of appointment to prevent a completed gift, the property might still be included in the beneficiary's estate pursuant to IRC 2036(a)(2) and/or 2038.
  - 1. SDCL § 55-2-15(2)(a) limits the power to decant unless held to an ascertainable standard if the trustee is also a beneficiary or if any beneficiary of the first trust has the right to change the trustees of the first trust. This would avoid estate inclusion.
- iv. Self-settled trusts are generally included in the grantor's estate if the assets can be reached by creditors.
  - 1. SDCL Ch. 55-16 allows self-settled spendthrift trusts, so decanting of a self-settled trust in South Dakota should not result in estate inclusion unless the trust is

moved to a state which does not allow self-settled trusts.

e. GST tax

- i. Recognized where property is transferred to a skip person.
- ii. Special considerations for grandfathered GST trusts.
  1. Irrevocable trusts established on or before September 25, 1985, are exempt from GST trusts and are thus called “grandfathered GST trusts” – see Tax Reform Act of 1986 §1433(b)(2)(C), as modified by the Revenue Reconciliation Act of 1990 §11703(c) and the Technical and Miscellaneous Revenue Act of 1988 §1014(h)(5).
  2. The IRS has held in numerous private letter rulings that if a modification does not result in any change in the quality, value, or timing of any beneficial interest under the trust, a grandfathered GST trust will not lose its exempt status.
  3. Grandfathered status may be lost if the trustee decants other than by state law in effect when the trust became irrevocable or by authority granted in the governing instrument.
    - a. No decanting statutes were in effect before September 25, 1985, so any state law in effect at the time a grandfathered GST trust became irrevocable would have been a common law power to decant.
  4. A distribution from a GST exempt trust to a new trust should not jeopardize exempt status if the terms of the governing trust or applicable state law at the time the trust became irrevocable authorize the distribution without beneficiary consent and if the new trust will not extend the time for vesting beyond any life in being at the date the original trust became irrevocable plus 21 years – see Reg. 23-2601-1(b)(4)(i)(A).

- f. Other taxes
    - i. State, local and property taxes.
      - 1. When moving trusts from one jurisdiction to another, or when changing applicable state law, these taxes may be avoided, decreased, or increased, depending upon the facts of the situation.
4. Alternatives
- a. Disclaimers.
  - b. Interpretation of the trust.
  - c. Amendment allowed by terms of trust.
  - d. Consent to and indemnification of the trustee's actions.
5. Pitfalls
- a. Changing the trust may trigger a no-contest clause.
    - i. No-contest clauses are unenforceable in South Dakota if probable cause exists for the challenge pursuant to SDCL § 29A-2-517.
    - ii. No-contest clauses governed by another state's law may be enforceable.
  - b. Cost
    - i. Attorneys fees, court costs, etc.
    - ii. If moving the trust from another jurisdiction, court proceedings and local counsel may be required in both jurisdictions.
  - c. Uncooperative beneficiary or co-trustee
    - i. Objections to proposed changes may tie things up in court.
  - d. Adverse tax consequences, as discussed above.

e. State law

- i. Procedural or substantive law in the original jurisdiction may prevent or hamper adjustments to trust.
- ii. Possible trigger of no-contest clauses, as discussed above.
- iii. It may be advisable to seek the opinion of or assistance from local counsel if moving a trust to or from another jurisdiction.
  - 1. Some jurisdictions will not allow trusts to move if there is a resident trustee or trust property located in that state.

f. Privacy concerns

- i. Trust files in South Dakota courts are permanently sealed upon any interested party's request pursuant to SDCL § 21-22-28.
- ii. Delaware and Alaska offer some limited privacy.
- iii. Trust proceedings in other states are a generally matter of public record.

6. Conclusion

- a. Many factors should be considered before modifying or decanting a trust or converting to a unitrust.
  - i. When to change the trust.
  - ii. Why to change the trust.
  - iii. Which method to use.
  - iv. Adverse or unintended tax consequences.
  - v. Other alternatives to meet desired goals.
  - vi. Other possible pitfalls.

- b. Changing an irrevocable trust may be done, and South Dakota is among the most favorable jurisdictions, if not the most favorable jurisdiction, in which to do so.

## TOTAL RETURN UNITRUST

### A. What are they?

1. A total return unitrust or a TRU is a trust in which the income beneficiary is entitled each year to a percentage of the net fair market value of the trust assets. The value of those assets would be calculated on the same day of each year.
2. The concept is similar to a charitable remainder unitrust under Internal Revenue Code (“IRC”) §664(d)(2).

### B. How can they be created?

1. By drafting a trust with unitrust provisions. (See Exhibit A for sample of such provisions.)
2. State law allows the conversion of an income-only trust to a TRU. SDCL Chapter 55-15. (See Exhibit B for copies of such statutes.)

### C. The genesis of these trusts comes mainly from modern portfolio series coupled with the prudent investor rule.

1. Modern portfolio theory finds its basis on the belief that markets are efficient. The old belief that one could pick investments based on various data such as prior performance, earnings potential, etc., is outweighed by using a broad base investment in the whole of the market. (A good discussion of modern portfolio theory can be found at Macy, An Introduction to Modern Financial Theory, 2d. Edition published by the American College of Trust and Estate Counsel Foundation.) This approach provides broad diversification and minimization of risk while experiencing the performance of the whole spectrum of investments.
2. The prudent investor rule, §2(a) of the Uniform Prudent Investment Act, adopted by South Dakota at SDCL §55-5-6 to 55-5-16 gives support to the modern portfolio. The rule has these basics:
  - a. Trustees should invest for total return;
  - b. Investments must be suitable for the purposes of the trust; and
  - c. In determining whether the trustee has acted with prudence

the entire portfolio must be looked at rather than each asset.

Finally, the trustee is still subject to the duties of loyalty and impartiality. (Restatement of Laws of Trusts, 3d. §27).

3. The high income/dividends of years past have been replaced by little or no dividends today.

#### D. Advantages of the TRU

1. There is a fairness in investing the trust assets and the matter to produce the best overall return. Instead of paying a small amount to the income beneficiary which represents the entire net income or investing for a high income return with little or no appreciation, is it not better to pay a fair overall percentage of the trust assets and give both the income and the remainder beneficiaries a better return?
2. Both the income and the remainder beneficiaries share in the good and bad times. If income goes down, then the valuation of the assets are reduced and the income beneficiary receives less and such is less impact to the remainder beneficiary. The remainder beneficiary gets more when the assets appreciate.
3. The trustee does not get polled by either the income or the remainder beneficiary since they are both served.
4. The decision on investing can be made more freely.
5. We eliminate the tension between the income and the remainder beneficiaries.

#### E. Disadvantages of the TRU

1. The arrangement provides very little flexibility.
  - a. Income percentage is fixed.
  - b. Trustee may not be able to address unusual circumstances.
2. Because of the potential inability to react, we may create a tension between the remainder and the income beneficiaries since the latter feels that they

are getting shorted.

a. Adding a traditional provision to the trust allowing a trustee some discretion may overcome this issue but this causes the trustee to be more cautious and not invest/act as freely.

3. Trustee may no longer be asked to do what we expect of trustees to exercise discretion.

4. Trust and the trustee lose some of the ability to invest in different approaches and that will most often adopt the modern portfolio investment methodology.

F. What assets work well with a TRU?

1. Liquid assets, cash, stocks, bonds, mutual funds, etc.

G. What assets do not work well?

1. Real estate,
2. Oil and gas interests
3. Closely held business interest
4. Limited partnership interests

H. TRU's are not a panacea but where appropriate if they fit grantor's objectives, they can become highly effective.

1. Second marriage. The use of a TRU can eliminate or minimize conflict between children and the second spouse. The arrangement should take most of the personalities out of the equation.

2. If you can adjust an income-only trust holding stock that has limited income, but no ability on the trustee to otherwise diversify (a single stock with limited marketability but specific direction to retain).

I. Alternatives to a TRU

1. Draft with greater flexibility.

a. Choose a competent and aggressive (fearless of lawsuit) trustee.



- b. Give considerable discretion to your trustee.
2. Allow the trustee to use Section 104 of the Uniform Principal and Income Act to adjust what is income and principal to provide a more level treatment to the income beneficiary remainderment. South Dakota has adopted the UPAIA and the ability to adjust is found at SDCL §55-13A-104.

J. Tax implications of a TRU

1. Establishing from the start there is little or no tax implication unless trying to qualify for the marital deduction under § 2056.
2. Income is defined under Treas. Reg. §1.643(b)-1 to include an allocation between income and principal as allowed by applicable state law and if such law allows a reasonable apportionment between income and remainder beneficiaries. The regulation goes on by example to say a 3-5% annual payout would be reasonable.

(South Dakota law provides such an allowed payout but not less than 3% under SDCL §55-15-6(3).)

3. With the change in the definition of income, a trust to benefit a spouse should qualify for the marital deduction under IRC §2056. (IRC §2056(b)(3)(B)(I)).
  - a. In order to qualify, the property must pass from the decedent;
  - b. Either surviving spouse must have a qualifying interest for life in the trust assets;
  - c. An election must be made to treat the arrangement as qualified terminable interest property.
4. Interesting Treas. Reg. §1.643(b)-1 also provides that a switch between methods determining trust income authorized under state law will not result in a recognition of gain under IRC §1001 or a taxable gift. Notwithstanding, if the conversation is outside state law perimeters, it could result in gain recognition or a taxable gift, depending upon the facts and circumstances.

5. Conversion to a TRU should have no direct impact to estate taxation of the trust. However conversion could impact the grandfathering of generation skipping transfer taxation. Treas. Reg. § 26.2601-1(b)(4)(D)(2) provides that if local law allows conversion and such conversion is a reasonable apportionment between the income and remainder beneficiaries in light of Treas. Reg. § 1.643(b)-1 then such conversion will not be considered a shift of a beneficial interest in the trust. As consequence the conversion should allow the continued grandfathered GST exempt treatment of the trust.

K. Conversion of an income trust to a TRU. (SDCL Chapter 55-15.)

1. SDCL §55-15-2 allows the trustee:
  - a. To convert to a unitrust from an income trust;
  - b. Reconvert from a unitrust to an income trust; or
  - c. Change the percentage of the unitrust amount.
2. The trustee must be a disinterested trustee.
  - a. The trustee can't be an income or principal beneficiary of the trust;
  - b. The trustee can't be removed or replaced by an interested distributee; or
  - c. The trustee can't have their legal obligations to support someone potentially satisfied from the income or principal of the trust.
3. The trustee must adopt a written policy setting forth how the trust may be changed.
4. The trustee must send written notice to take action along with the written policy to
  - a. Grantor, if living;
  - b. All living persons currently receiving or eligible to receive distributions of income;
  - c. All living persons who would receive principal of the trust, if the trust were to end at the time of notice; and
  - d. All persons acting as an advisor or protector of the trust.
5. At least one person receiving notice in (b) and (c) above must be legally

competent, and no person receiving notice may object in writing within 60 days of receiving the notice.

6. An interested trustee may appoint a disinterested person who can assist the interested trustee at arriving at the percentage payout, the method to arrive at fair market value, and which assets will be excluded from the unitrust amount. (SDCL §55-15-3).
7. If outside of SDCL §§55-15-2 or 55-15-3, or if the trustee receives an objection to the proposed action, the trustee may petition the court for an order that the trustee deems appropriate (SDCL §55-15-4).
8. An annual valuation of the assets is required (SDCL §55-15-5).
9. Calculation of the unitrust amount (SDCL §55-15-6)
  - a. During the first three accounting periods (years), the percentage shall be 3% or higher of the current year asset value;
  - b. In the fourth accounting period, again 3% or higher, but now of the prior three year averages of assets;
  - c. Percentages must be 3% or higher and all years (can it be more than 5%?)
  - d. Pro rate for short tax years; and
  - e. Be mindful of the rules on valuation contained in the statute.
10. Note also the conversion to a unitrust does not affect any other provision of the trust regarding distribution of principal (SDCL §55-15-10).

L. As an estate planner drafting documents, what do we do?

1. William Hoisington speaking at the Heckerling Institute on Estate Planning in 1997 suggested the following when looking at distribution formulas and specifically the use of TRUs.
  - a. Have a reasonably clear understanding of the grantor's human and financial objectives for the trust.
  - b. Have a clear understanding of the personal circumstances and financial needs of the trust beneficiaries both present and future.

- c. Have some understanding of modern financial principals and the supporting empirical data.
- d. Have a reasonable understanding of the investment strategies that are likely to be employed by the trustee and of the probable financial consequences of each of those strategies.
- e. Have expert level knowledge of alternative distribution designs and constituent distribution formula that may be used to implement the grantor's human and financial objectives of the trust.

If we adhere to these concepts as estate planners, we should be able to develop a plan that meets the goals and needs of our grantors without burdening the beneficiaries or the trustee.

# EXHIBIT A

**SAMPLE UNITRUST LANGUAGE**  
**(Use carefully - Not for every situation!)**

The Trustee shall distribute the remaining trust property to our living child and to the descendants of her if she is deceased by right of representation. The share for our child, shall be administered and distributed as provided hereafter. The share for descendants of a deceased child shall be administered in paragraph \_\_\_\_\_ hereafter.

1. The Trustee in each taxable year of the Trust shall pay to our daughter during her life a unitrust amount equal to 5% of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust (“Valuation Day”). The unitrust amount shall be paid in, at least, equal quarterly amounts from the net income, and, to the extent the income is not sufficient from principal. [OPTIONAL - Any income of the Trust for a taxable year in excess of the unitrust amount shall also be paid to our daughter as soon as practical after determining such amount.] If for any year the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined, the Trustee shall pay to our daughter (in the case of an under valuation) or received from our daughter (in the case of an over valuation) an amount equal to the difference between the unitrust amount properly payable and the unitrust amount actually paid.
2. The obligation to pay the unitrust amount shall commence with the date of death of the survivor of us. The payment of the unitrust amount may be deferred from such date until the end of the taxable year of the trust in which occurs the complete funding of the Trust.
3. In determining the unitrust amount, the Trustee shall prorate the same on a daily for a short year or for a taxable year ending with our daughter’s death.
4. The taxable year of the Trust shall be the calendar year.

5. Nothing in this article shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in an annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

[OPTIONAL]6. The Trustee shall from time to time pay to our daughter or apply for her benefit such sums from the principal of this Trust as our Trustee may in their sole discretion determine to be necessary or desirable for her health, support, maintenance, and best interests commensurate with the life style she enjoyed during our life times.

7. Upon our daughter's death the remaining principal shall be distributed according to paragraph \_\_\_\_ hereafter.

# EXHIBIT B



**\*63008 SDCL § 55-15-1**

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**55-15-1. Definitions**

Terms used in this chapter mean:

- (1) "Disinterested person," any person who is not a related or subordinate party, as defined in section 672(c) of the Internal Revenue Code (26 U.S.C. section 1, et seq.), with respect to the person then acting as trustee of the trust and excludes the trustor of the trust and any interested trustee;
- (2) "Income trust," any trust, created by either an inter vivos or a testamentary instrument, which directs or permits the trustee to distribute the net income of the trust to one or more persons, either in fixed proportions or in amounts or proportions determined by the trustee. However, no trust that otherwise is an income trust may qualify pursuant to this subdivision, if it is subject to taxation under I.R.C. section 2001 or section 2501, until the expiration of the period for filing the return therefor (including extensions);
- (3) "Interested distributee," any person to whom distributions of income or principal can currently be made who has the power to remove the existing trustee and designate as successor a person who may be a related or subordinate party, as defined in I.R.C. section 672(c), with respect to such distributee;
- (4) "Interested trustee," (i) any individual trustee to whom the net income or principal of the trust can currently be distributed or would be distributed if the trust were then to terminate and be

distributed, or (ii) any trustee who may be removed and replaced by an interested distributee, or (iii) any individual trustee whose legal obligation to support a beneficiary may be satisfied by distributions of income and principal of the trust, or (iv) any of the above;

(5) "Total return unitrust," any income trust which has been converted under and meets the provisions of this chapter;

**\*63009** (6) "Trustee," all persons acting as trustee of the trust, except where expressly noted otherwise, whether acting in their discretion or on the direction of one or more persons acting in a fiduciary capacity;

(7) "Trustor," any individual who created an inter vivos or a testamentary trust;

(7A) "Unitrust," a trust, the terms of which require or permit distribution of a unitrust amount, without regard to whether the trust has been converted to a unitrust in accordance with this chapter or whether the trust is established by express terms of the governing instrument;

(8) "Unitrust amount," an amount equal to a percentage of a unitrust's assets that may or are required to be distributed to one or more beneficiaries annually in accordance with the terms of the unitrust. The unitrust amount may be determined by reference to the net fair market value of the unitrust's assets as of a particular date each year or as an average determined on a multiple year basis;

(9) "Current valuation year," the accounting period of the trust for which the unitrust amount is being determined;

(10) "Prior valuation year," each of the two accounting periods of the trust immediately preceding the current valuation year; and

(11) "I.R.C.," the Internal Revenue Code (26 U.S.C. section 1, et seq.).

**CREDIT(S)**

*Source: SL 2002, ch 225, § 1; SL 2009, ch 252, § 45.*

<General Materials (GM) - References, Annotations, or Tables>


**HISTORICAL NOTES**

**HISTORICAL AND STATUTORY  
NOTES**

SL 2009, ch 252, § 45 inserted subd. (7A) and rewrote subd. (8), which read: "'Unitrust amount,' an amount computed as a percentage of the fair market value of the trust".

**REFERENCES**

**LIBRARY REFERENCES**

Trusts  273, 273.5.

Westlaw Key Number Searches: 390k273; 390k273.5.  
C.J.S. Trusts §§ 539 to 550.

**REFERENCES**

**RESEARCH REFERENCES**

Treatises and Practice Aids

\***63010** SH069 American Law Institute-American Bar Association 1913.

SH022 American Law Institute-American Bar Association 1843.

**\*63011 SDCL § 55-15-2**

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**55-15-2. Trustee's authority to convert  
income trust, total return unitrust--  
Calculate trust amount, value--  
Conditions**

A trustee, other than an interested trustee, or, if two or more persons are acting as trustee, a majority of the trustees who are not an interested trustee (in either case hereafter "trustee"), may, in its sole discretion and without the approval of any court, (i) convert an income trust to a total return unitrust, (ii) reconvert a total return unitrust to an income trust, or (iii) change the percentage used to calculate the unitrust amount and the method used to determine the fair market value of the trust if:

(1) The trustee adopts a written policy for the trust providing (i) in the case of a trust being administered as an income trust, that future distributions from the trust will be unitrust amounts rather than net income, (ii) in the case of a trust being administered as a total return unitrust, that future distributions from the trust will be net income rather than unitrust amounts, or (iii) that the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust will be changed as stated in the policy;

(2) The trustee sends written notice of its intention to take such action, along with copies of such written policy and this chapter, to (i) the trustor, if living, (ii) all living persons who are currently receiving or eligible to receive distributions of income of the trust, (iii) all living persons who would receive principal of the trust if the trust were to terminate at the time of the giving of such notice (without regard to the exercise of any power of appointment) or, if the trust does not provide for its termination, all living persons who would receive or be eligible to receive distributions of income or principal of the trust if the persons identified in subclause (ii) of this subdivision were deceased, and (iv) all persons acting as adviser or protector of the trust;

(3) At least one person receiving notice under each of subclauses (ii) and (iii) of subdivision (2) is, to the best information and belief of the trustee, legally competent; and

**\*63012** (4) No person receiving such notice objects, by written instrument delivered to the trustee, to the proposed action of the trustee within sixty days of receipt of such notice.

**CREDIT(S)**

*Source: SL 2002, ch 225, § 2.*

<General Materials (GM) - References, Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts ⌘58.  
Westlaw Key Number Search: 390k58.  
C.J.S. Trusts §§ 96 to 102.

**\*63013 SDCL § 55-15-3**

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**55-15-3. Interested trustee's authority over  
actions enumerated in § 55-15-2--  
Conditions**

If there is no trustee of the trust other than an interested trustee, the interested trustee or, if two or more persons are acting as trustee and are interested trustees, a majority of such interested trustees, may, in its sole discretion and without the approval of any court, take such action as

provided in § 55-15-2 so long as the trustee appoints a disinterested person who, in its sole discretion but acting in a fiduciary capacity, determines for the trustee (i) the percentage to be used to calculate the unitrust amount, (ii) the method to be used in determining the fair market value of the trust, and (iii) which assets, if any, are to be excluded in determining the unitrust amount; and complies with all of the provisions of subdivisions (1) to (4), inclusive, of § 55-15-2.

**CREDIT(S)**

*Source: SL 2002, ch 225, § 3.*

<General Materials (GM) - References,  
Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts ☞ 171.  
Westlaw Key Number Search: 390k171.  
C.J.S. Trusts §§ 318 to 320.

\*63014 SDCL § 55-15-4

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**55-15-4. Trustee may petition court--  
Appointment of disinterested person**

If any trustee desires to (i) convert an income trust to a total return unitrust, (ii) reconvert a total return unitrust to an income trust, or (iii) change the percentage used to calculate the unitrust amount and the method used to determine the fair market value of the trust but does not have the ability to or elects not to do it under the provisions of §§ 55-15-2 and 55-15-3, or in the event the trustee receives a written objection within the applicable period, the trustee may petition the

court for such order as the trustee deems appropriate. In the event, however, there is only one trustee of such trust and such trustee is an interested trustee or in the event there are two or more trustees of such trust and a majority of them are interested trustees, the court, in its own discretion or on the petition of such trustee or trustees or any person interested in the trust, may appoint a disinterested person who, acting in a fiduciary capacity, shall present such information to the court as shall be necessary to enable the court to make its determination.

**CREDIT(S)**

*Source: SL 2002, ch 225, § 4.*

<General Materials (GM) - References,  
Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts ☞ 177.  
Westlaw Key Number Search: 390k177.  
C.J.S. Trusts §§ 347 to 348, 350 to 360.

**\*63015 SDCL § 55-15-5**

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**55-15-5. Annual valuation of trust required**

The fair market value of the trust shall be determined at least annually, using such valuation date or dates or averages of valuation dates as are deemed appropriate. Assets for which a fair market value cannot be readily ascertained shall

be valued using such valuation methods as are deemed reasonable and appropriate. Such assets may be excluded from valuation, if all income received with respect to such assets is distributed to the extent distributable in accordance with the terms of the governing instrument.

**CREDIT(S)**

*Source: SL 2002, ch 225, § 5.*

<General Materials (GM) - References,  
Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts ☞270.  
Westlaw Key Number Search: 390k270.  
C.J.S. Trusts §§ 321 to 324, 330 to 331.

**\*63016 SDCL § 55-15-6**

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**55-15-6. Calculation of unitrust amount**

The unitrust amount shall be determined as follows:

- (1) For the first three accounting periods of the trust, the unitrust amount for a current valuation year of the trust shall be three percent, or such higher percentage specified by the terms of the governing instrument or by the election of the trustee, the disinterested person, or the court, of the net fair market value of the assets held in the trust on the valuation date of the current valuation year;
- (2) Beginning with the fourth accounting period of the trust, the unitrust amount for a current valuation year of the trust shall be three percent, or such higher percentage specified by the terms of the governing instrument or by the election of the trustee, the disinterested person, or the court, of the average of the net fair market value of the assets held in the trust on the valuation date of the current valuation year and the net fair market value of the assets held in the trust on the valuation date of each prior valuation year, as defined in subdivision 55-15-1(10);
- (3) The percentage that may be elected by the trustee, the disinterested person, or the court in determining the unitrust amount shall be a reasonable current return from the trust, taking into account the intentions of the trustor of the trust as expressed in the governing instrument, the needs of the beneficiaries, general economic conditions,

projected current earnings and appreciation for the trust, and projected inflation and its impact on the trust. However, such election by the trustee, the disinterested person, or the court in determining the unitrust amount shall be three percent or greater;

(4) The unitrust amount for the current valuation year shall be proportionately reduced for any distributions, in whole or in part, other than distributions of the unitrust amount, and for any payments of expenses, including debts, disbursements and taxes, from the trust within a current valuation year that the trustee determines to be material and substantial, and shall be proportionately increased for the receipt, other than a receipt that represents a return on investment, of any additional property into the trust within a current valuation year;

**\*63017** (5) In the case of a short accounting period, the trustee shall prorate the unitrust amount on a daily basis;

(6) If the net fair market value of an asset held in the trust has been incorrectly determined either in a current valuation year or in a prior valuation year, the unitrust amount shall be increased in the case of an undervaluation, or be decreased in the case of an overvaluation, by an amount equal to the difference between the unitrust amount determined based on the correct valuation of the asset and the unitrust amount originally determined;

(7) In determining the net fair market value of the assets held in trust, the determination may not include the value of any residential property or any tangible personal property that, as of the first business day of the current valuation year, one or more income beneficiaries of the trust have or had the right to occupy, or have or had the right to possess or control, other than in a capacity as trustee, and instead the right of occupancy or the right of possession or control shall be deemed to be the unitrust amount with respect to the residential property or the tangible personal property; or any asset specifically given to

a beneficiary under the terms of the trust and the return on investment on that asset, which return on investment shall be distributed to the beneficiary.

### CREDIT(S)

*Source: SL 2002, ch 225, § 6; SL 2004, ch 312, § 7; SL 2005, ch 260, § 9; SL 2009, ch 252, § 39.*

<General Materials (GM) - References, Annotations, or Tables>

### HISTORICAL NOTES

#### HISTORICAL AND STATUTORY NOTES

SL 2004, ch 312, § 7, in subd. (2), added ", as defined in subd. 55-15-1(10)".

SL 2005, ch 260, § 9, rewrote subd. (3), which read:

"(3) The percentage that may be elected in determining the unitrust amount shall be a reasonable current return from the trust, taking into account the intentions of the trustor of the trust as expressed in the governing instrument, the needs of the beneficiaries, general economic conditions, projected current earnings and appreciation for the trust, and projected inflation and its impact on the trust. However, if such percentage is three percent or greater, or if no percentage is specified, then that percentage shall be three percent;"

**\*63018** SL 2009, ch 252, § 39, in subds. (1) and (2) substituted "valuation date" for "first business day".

### REFERENCES

#### LIBRARY REFERENCES

Trusts ☞ 273, 273.5.

Westlaw Key Number Searches: 390k273; 390k273.5.

C.J.S. Trusts §§ 539 to 550.



**\*63020 SDCL § 55-15-8**

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**55-15-8. Unitrust amount as net income of  
trust--Allocation of capital gains to  
trust income**

Following the conversion of an income trust to  
a total return unitrust, the trustee:

- (1) Shall treat the unitrust amount as if it  
were net income of the trust for purposes  
of determining the amount available, from  
time to time, for distributions from the  
trust; and
- (2) May allocate to trust income for each  
taxable year of the trust (or portions  
thereof) (i) net short-term capital gain  
described in I.R.C. section 1222(5) for

such year (or portion thereof) but only to  
the extent that the amounts so allocated  
together with all other amounts allocate to  
trust income for such year (or portion  
thereof) does not exceed the unitrust  
amount for such year (or portion thereof);  
and (ii) net long-term capital gain  
described in I.R.C. section 1222(7) for  
such year (or portion thereof) but only to  
the extent that the amount so allocated  
together with all other amounts, including  
amounts described in clause (i) above,  
allocated to trust income for such year (or  
portion thereof) does not exceed the  
unitrust amount for such year (or portion  
thereof).

**CREDIT(S)**

*Source: SL 2002, ch 225, § 8.*

<General Materials (GM) - References,  
Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts ☞ 272.1, 272.2.  
Westlaw Key Number Searches: 390k272.1; 390k272.2.  
C.J.S. Trusts §§ 551, 553 to 554.

**\*63021 SDCL § 55-15-9**

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**55-15-9. Administration of total return  
unitrust--Authority of trustee**

In administering a total return unitrust, the trustee may, in its sole discretion but subject to the provisions of the governing instrument, determine:

- (1) The effective date of the conversion;
- (2) The timing of distributions (including provisions for prorating a distributions for a short year in which a beneficiary' right to

- payments commences or ceases);
- (3) Whether distributions are to be made in cash or in kind or partly in cash and partly in kind;
  - (4) If the trust is reconverted to an income trust, the effective date of such reconversion; and
  - (5) Such other administrative issues as may be necessary or appropriate to carry out the purposes of this chapter.

**CREDIT(S)**

*Source: SL 2002, ch 225, § 9.*

<General Materials (GM) - References, Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts ☞271.  
Westlaw Key Number Search: 390k271.  
C.J.S. Trusts §§ 318 to 320.

**\*63022 SDCL § 55-15-10**

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**55-15-10. Distributions of principal not  
affected by conversion**

Conversion to a total return unitrust under the

provisions of this chapter does not affect any other provisions of the governing instrument, if any, regarding distributions of principal.

**CREDIT(S)**

*Source: SL 2002, ch 225, § 10.*

<General Materials (GM) - References,  
Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts ☞276.

Westlaw Key Number Search: 390k276.

C.J.S. Trusts §§ 539 to 541.

**\*63023 SDCL § 55-15-11**

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**55-15-11. Spouse may compel reconversion  
to income trust for certain trusts--  
Written instrument required**

In the case of a trust for which a marital deduction has been taken for federal tax purpose under I.R.C. section 2056 or 2523, the spouse

otherwise entitled to receive the net income of the trust has the right, by written instrument delivered to the trustee, to compel the reconversion during his or her lifetime of the trust from a total return unitrust to an income trust, notwithstanding anything in this chapter to the contrary.


**CREDIT(S)**

*Source: SL 2002, ch 225, § 11.*

<General Materials (GM) - References, Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts  58.  
Westlaw Key Number Search: 390k58.  
C.J.S. Trusts §§ 96 to 102.

**\*63024 SDCL § 55-15-12**

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**55-15-12. Applicability of chapter**

This chapter shall be construed as pertaining to the administration of a trust and shall be available to any trust that is administered in South Dakota under South Dakota law unless (i) the governing instrument reflects an intention that the current beneficiary or beneficiaries are to receive an amount other than a reasonable current return from the trust, ii) the trust is a trust described in I.R.C. section 170(f)(2)(B), 6664(d), 1361(d), 2702(a)(3), or 2702(b), (iii) one or more persons to whom the trustee could distribute income have

a power of withdrawal over the trust that is not subject to an ascertainable standard under I.R.C. section 2041 or 2514 or that can be exercised to discharge a duty of support he or she possesses, or (iv) the governing instrument expressly prohibits use of this chapter by specific reference to the chapter. A provision in the governing instrument that "The provisions of this chapter, or any corresponding provision of future law, may not be used in the administration of this trust" or similar words reflecting such intent are sufficient to preclude use of this chapter.

**CREDIT(S)**

*Source: SL 2002, ch 225, § 12.*

<General Materials (GM) - References, Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts ↻ 273, 273.5.  
Westlaw Key Number Searches: 390k273; 390k273.5.  
C.J.S. Trusts §§ 539 to 550.

**\*63025 SDCL § 55-15-13**

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**55-15-13. Trustee acting in good faith not  
liable--Remedy**

Any trustee or disinterested person who in good faith takes or fails to take any action under this chapter is not liable to any person affected by such action or inaction, regardless of whether such person received written notice as provided in this

chapter and regardless of whether such person was under a legal disability at the time of the delivery of such notice. Such person's exclusive remedy shall be to obtain an order of the court directing the trustee to convert an income trust to a total return unitrust, to reconvert from a total return unitrust to an income trust or to change the percentage used to calculate the unitrust amount.

**CREDIT(S)**

*Source: SL 2002, ch 225, § 13.*

<General Materials (GM) - References,  
Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

Trusts ☞ 179.  
Westlaw Key Number Search: 390k179.  
C.J.S. Trusts §§ 321 to 324, 326.

\*63026 SDCL § 55-15-14

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and Supreme Court Rule 09-09*

**55-15-14. No duty to act created**

Nothing in this chapter is intended to create or imply a duty to take any action under this chapter, and no trustee is liable for not considering whether to take any action or for choosing not to take any such action.

**CREDIT(S)**

*Source: SL 2002, ch 225, § 14.*

<General Materials (GM) - References,  
Annotations, or Tables>

**REFERENCES**

**LIBRARY REFERENCES**

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C.J.S. Trusts §§ 321 to 324, 326.

**REFERENCES**

**RESEARCH REFERENCES**

Treatises and Practice Aids

SH069 American Law Institute-American Bar Association  
1913.

SH022 American Law Institute-American Bar Association  
1843.

\*63027 SDCL § 55-15-15

**charitable remainder unitrust**

**SOUTH DAKOTA CODIFIED  
LAWS  
TITLE 55. FIDUCIARIES AND  
TRUSTS  
CHAPTER 55-15. TOTAL  
RETURN UNITRUSTS**

This chapter does not apply to a charitable remainder unitrust as defined by § 664(d) of the Internal Revenue Code of 1986 (26 U.S.C. § 664), as of January 1, 2009.

**CREDIT(S)**

*Current through the 2009 Regular Session  
and Supreme Court Rule 09-09*

*Source: SL 2009, ch 252, § 38.*

**55-15-15. Chapter not applicable to**

<General Materials (GM) - References,  
Annotations, or Tables>



# Who is Entitled to a Copy of the Trust and When

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# WHO IS ENTITLED TO A COPY OF THE TRUST AND WHEN

Presented by  
**Jayna M. Voss**

## **I. Overview of South Dakota Laws Governing Trusts**

### **A. SDCL Title 55 - Fiduciaries and Trusts**

1. Title 55 is the starting point for general laws governing trusts. Some of the relevant Chapters under this Title include Chapter 55-1A which sets forth general trustee powers; Chapter 55-2 which delineates duties and liabilities of trustees; Chapters 55-1B and 55-3 which set forth provisions governing directed trusts and express trusts; Chapter 55-4 which contains provisions from the Uniform Trusts Act, and Chapter 55-5 which describes the investment and management powers of fiduciaries.
2. The 2010 legislature has clarified that Chapter 55-3 applies to all trusts – not just third party trusts.
3. There is some overlap with a few other Code provisions, specifically with Chapter 21-22 and Chapter 29A-3.

### **B. SDCL Chapter 21-22 - Administration of Trust Estates**

1. Chapter 21-22 applies to all trusts if any part of the trust estate has its situs in the state or if beneficiary or trustee resides here, except as otherwise provided by statute or rule of court.
2. Essentially this Chapter applies to court trusts or other non-judicial trusts where a petition for court-supervision is filed.

### **C. SDCL Chapter 29A-3 – Probate of Wills and Administration**

1. The probate Chapter contains some provisions that govern testamentary trusts.

## **II. Confidentiality and Privacy**

### **A. Why a Trust?**

1. One of the advantages of having a trust is that it is not a public record.
2. The administration and settlement of a trust is a private family matter.

3. Privacy and confidentiality are primary benefits of a trust and must be protected by attorneys and trustees.

**B. Duty to Protect Confidentiality and Privacy**

1. A trustee has a duty to preserve the confidentiality and privacy of a trust except where required by law or as necessary to administer the trust. REST 3d TRUSTS § 78.
2. SDCL § 55-2-1 provides that “[i]n all matters connected with his trust a trustee is bound to act in the highest good faith toward his beneficiary[.]”
3. Rule of Professional Conduct 1.6 sets forth that “[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent except for disclosures that are impliedly authorized in order to carry out the representation or the disclosure is permitted”.

**III. Who is Entitled to a Copy of the Trust?**

**A. Beneficiaries**

1. Do beneficiaries have a property right to a trust that entitles them to trust information?
  - a. In the case of Estate of Sigourney, 113 Cal.Rptr.2d 274, 283 (Cal. App. 2001), the court expressed that even “[t]o the extent that a remote interest is more amorphous than a contingent interest, we point out that even remote interests are entitled to a measure of due process. (*Mullane v. Central Hanover Tr. Co.* (1950) 339 U.S. 306, 317-318, 70 S.Ct. 652, 94 L.Ed. 865 [notice by publication to unknown trust beneficiaries, “many of whose interests in the common fund are so remote as to be ephemeral,” sufficient for due process purposes].) Here, no due process was afforded to appellants.”
2. Prior to being made irrevocable, the trustee is ordinarily not allowed to disclose information to remainder beneficiaries in order to preserve confidentiality and privacy of the trustor.
3. The duty of confidentiality typically does not apply to the disclosure of trust information to the beneficiaries of the trust or to their authorized representatives. However, even when providing information to beneficiaries the trustee has a duty to act with sensitivity for the privacy of the trust beneficiaries. REST 3d TRUSTS § 78.

- a. the *Restatement of Trusts* sets forth that “fiduciary principles include (i) the general duty to act, reasonably informed, with impartiality among the various beneficiaries and interests and (ii) the duty to provide the beneficiaries with information concerning the trust and its administration. This combination of duties entitles the beneficiaries (and also the court) not only to accounting information but also to relevant, general information concerning the bases upon which the trustee's discretionary judgments have been or will be made.... It is contrary to sound policy, and a contradiction in terms, to permit the settlor to relieve a ‘trustee’ of all accountability.” *Id.* at § 50 cmts. b and c at 260-62 (2003) (internal references omitted).
  - b. In the case of Johnson v. Johnson, 967 A.2d 274 (Md. App. 2009) the remainder beneficiary was found to be entitled to an accounting despite trust language that expressly released the trustee from the obligation to provide an accounting.<sup>2</sup> The court also found that even though uncertainty existed as to whether the remainder beneficiary would ever benefit from the future interest under the trust,<sup>3</sup> the remainder beneficiary was still entitled to an accounting of both Trust A and Trust B.<sup>4</sup>
4. SDCL § 55-2-13 was amended by the South Dakota Legislature in the 2010 session. This statute allows only a “Qualified Beneficiary” to receive a copy of the trust instrument. SDCL § 55-2-13 (with additions shown in highlights and deletions shown as lines) provides as follows:

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<sup>2</sup> The trust language stated:

The TRUSTEE shall not be required at any time to file any account in any court, nor shall the TRUSTEE be required to have any account judicially settled....only the information concerning the benefits held for or distributable to any particular beneficiary be revealed to such beneficiary and that no person shall be entitled to information concerning benefits held for or distributable to any other person.

Johnson, 967 A.2d at 281 (emphasis in original).

<sup>3</sup> Under the language of the trust, the wife had the discretion to redirect the remainder of the trust assets and only the wife had a present interest in the trust. The court also determined that the son who had a future interest in trust, contingent upon his surviving his stepmother, was a property interest properly deemed a remainder interest. Further, the beneficiary's remainder interest in trust share, which could be defeated if his stepmother exercised her power of appointment to exclude him from the proceeds of the trust, was contingent and not vested. After making these determinations, the court succinctly noted that “[i]f the petitioner has any interest at all he is entitled to invoke the court’s protection.” Johnson, 967 A.2d at 280-81.

<sup>4</sup> The court opined: “While Catherine is living, she has access to both trusts and the management of Trust A potentially affects the proceeds available for Trust B. In short, the trusts are inextricably linked and limiting James’s right to an accounting of Trust B will not satisfy the trustee’s legal responsibility to him.” Johnson, 967 A.2d at 281.

For purposes of this section, the term, qualified beneficiary, means a beneficiary who is twenty-one years of age and who, on the date the beneficiary's qualification is determined:

- (1) Is a distributee or permissible distributee of trust income or principal;
- (2) Would be a distributee or permissible distributee of trust income or principal if the interests of the distributees terminated on that date; or
- (3) Would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date.

Except as otherwise provided by the terms of a revocable trust, a trustee has no duty to notify the qualified beneficiaries of the trust's existence. Except as otherwise provided by the terms of an irrevocable trust or otherwise directed by the settlor, distribution advisor, or trust protector, the trustee shall, within sixty days after the trustee has accepted trusteeship of the trust, or within sixty days after the date the trustee acquires knowledge that a formerly revocable trust has become irrevocable, notify the qualified beneficiaries of the trust's existence and of the right of the beneficiary to request a copy of the trust instrument pertaining to the beneficiary's interest in the trust.

Subject to the previous provision, a trustee of an irrevocable trust:

- (1) Upon request of a qualified beneficiary, shall promptly furnish to the qualified beneficiary a copy of the trust instrument;
- (2) If notification of the trust has not been accomplished pursuant to this section within sixty days after accepting a trusteeship, shall notify the qualified beneficiaries of the acceptance and of the trustee's name, address, and telephone number;
- (3) Shall promptly respond to a qualified beneficiary's request for information related to the administration of the trust, unless the request is unreasonable under the circumstances.

A beneficiary may waive the right to the notice or information otherwise required to be furnished under this section and, with respect to future reports and other information, may withdraw a

waiver previously given. The change in the identity of a trustee, occurring as the result of a mere name change or a merger, consolidation, combination, or reorganization of a trustee, does not require notice. If a fiduciary is bound by a duty of confidentiality with respect to a trust or its assets, a fiduciary may require that any beneficiary who is eligible to receive information pursuant to this section be bound by the duty of confidentiality that binds the trustee before receiving such information from the trustee.

A trust advisor, trust protector, or other fiduciary designated by the terms of the trust shall keep each excluded fiduciary designated by the terms of the trust reasonably informed about:

- (1) The administration of the trust with respect to any specific duty or function being performed by the trust advisor, trust protector, or other fiduciary to the extent that the duty or function would normally be performed by the excluded fiduciary or to the extent that providing such information to the excluded fiduciary is reasonably necessary for the excluded fiduciary to perform its duties; and
- (2) Any other material information that the excluded fiduciary would be required to disclose to the qualified beneficiaries under this section regardless of whether the terms of the trust relieve the excluded fiduciary from providing such information to qualified beneficiaries. Neither the performance nor the failure to perform of a trust advisor, trust protector, or other fiduciary designated by the terms of the trust as provided in this subdivision shall affect the limitation on the liability of the excluded fiduciary.

The provisions of this section are effective for trusts created after July 1 **June 30**, 2002, except as otherwise directed by the settlor, trust protector, or distribution trust advisor. **For trusts created before July 1, 2002, a trustee has no duty at common law or otherwise to notify a qualified beneficiary of the trust's existence unless otherwise directed by the settlor.**

5. SDCL § 29A-3-705 sets forth that heirs and devisees of a testamentary trust must receive a copy of the will admitted to probate no later than fourteen days after appointment of the personal representative.

## **B. Third Parties**

1. There are a number of third parties who must be provided with certain trust information in order to help properly administer the trust and/or to

close a trust. Commonly, a trustee will work with banks, title companies, and financial institutions.

2. SDCL § 55-1A-31 authorizes a trustee to “employ attorneys, accountants, investment advisors, agents or other persons[.]”
3. SDCL § 55-1A-38 provides that “[a] trustee may perform such other acts, which, in the judgment of the trustee, may be necessary or appropriate for the proper management, investment, and distribution of the trust estate.”
4. SDCL §§ 55-1A-31 and 55-1A-38 give implied authority for the trustee to provide a third party with trust information in order for the third party to perform.
5. In order to protect the confidentiality and privacy of a trust, a certificate of trust should be used when possible rather than disclosing the entire trust instrument.
6. The trust’s accountant is one exception where a copy of the entire trust instrument is advisable to be given to a third party. The accountant for the trust should receive a copy of the trust instrument in order to understand any classification, instructions and/or apportionment of estate and income taxes; allocation and distributions of trust income and principal; and authority of trustee in settling and compromising claims filed against the trust and other administrative duties with tax implications. It is important to keep in mind that there is no “accountant-client privilege” so information shared with an accountant is not protected as privileged confidential information.
7. SDCL § 55-4-51 was amended by the South Dakota Legislature in the 2010 session and provides that instead of furnishing a copy of the trust instrument to a third party, the trustee may provide a certificate of trust. (Note: SDCL §§ 55-4-42 to 55-4-47, inclusive, were repealed by the South Dakota Legislature in 2010.) Specifically, SDCL § 55-4-51 (with additions shown in highlights and deletions shown as lines) provides as follows:

Instead of furnishing a copy of the trust instrument **or a copy of a will that creates a testamentary trust** to a person other than a beneficiary, ~~the trustee~~ **one or more trustees** may furnish to the person a certificate of trust **signed by a trustee, settlor, grantor, trustor, or trust protector**, containing the following information:

- (1) ~~That~~ **A statement that** the trust exists, **the name of the trust if one has been given**, and the date the trust instrument **or will** was executed;

- (2) The identity **name** of the settlor, **grantor, trustor, testator, or testatrix**;
- (3) The identity **name of each original trustee** and **the name and** address of the **currently acting each trustee and each trust protector currently empowered to act under the trust instrument or will on the date of the execution of the certificate of trust**;
- (4) The powers of the trustee **and the trust protector and other provisions set forth in the trust instrument or will as are selected by the person signing the certificate of trust, including those powers authorizing the trustee to sell, convey, pledge, mortgage, lease, or transfer title to any interest in property held in the trust, together with a statement setting forth the number of trustees required by the provisions of the trust instrument or will to act**;
- (5) The ~~revocability or irrevocability of the trust and~~ **A statement that the trust is irrevocable or, if the trust is revocable, a statement to that effect and** the identity of any person holding a power to revoke the trust, **and, if applicable, a statement that the trust has been terminated or revoked**;
- (6) ~~The authority of cotrustees to sign or otherwise authenticate and whether all or less than all are required in order to exercise powers of the trustee~~ **A statement that the trust is not supervised by a court, or, if applicable, a statement that the trust is supervised by a court, and which statement also sets forth any restrictions imposed by the court on the trustee's ability to act as otherwise permitted by statute or the terms of the trust instrument or will**;
- (7) ~~The manner of taking title to trust property.~~ **If applicable, a description of any property to be conveyed by the trustee**;

~~A certificate of trust may be signed or otherwise authenticated by any trustee.~~

- (8) A certificate of trust must state **statement** that the trust has not been ~~revoked, modified, or amended~~ in any manner that would cause the representations contained in the certificate of trust to be incorrect.



**The person signing the certificate shall certify that the statements contained in the certificate are true and correct. The signature of the person signing the certificate shall be acknowledged or verified under oath before a notary public or other official authorized to administer oaths.** A certificate of trust need not contain the dispositive terms of a trust.

8. In addition to amending SDCL § 55-4-51, the South Dakota Legislature also added a new section to chapter 55-4 in 2010, which reads as follows:

A certificate of trust executed under § 55-4-51 may be recorded in the office of the register of deeds with respect to land described in the certificate of trust or any attachment to it. If it is recorded or filed in any county where real property is situated, or in the case of personal property, if it is presented to a third party, the certificate of trust serves to document the existence of the trust, the identity of the trustees, the powers of the trustees, and any limitations on those powers, and other matters the certificate of trust sets out, as though the full trust instrument had been recorded, filed, or presented. Until amended or revoked under § 55-4-44, or until the full trust instrument or will is recorded, filed, or presented, a certificate of trust is conclusive proof as to the matters contained in it and any party may rely upon the certificate, except a party dealing directly with the trustee or trustees who have actual knowledge of the facts to the contrary.

Senate Bill 103.

9. There is no specific statute or case law providing mandatory authority requiring the trustee to provide or deny a third party a copy of a trust instrument.
10. In the event a situation arises where a third party is demanding a copy of the trust and it becomes necessary to provide said party with further trust information in addition to the certificate of trust, the trustee should provide only certain relevant provisions of the trust to said third party rather than providing the entire trust instrument. SDCL § 55-4-52 provides that “[a] recipient of a certificate of trust may require the trustee to furnish copies of those excerpts from the original trust instrument and later amendments that designate the trustee and confer on the trustee the power to act in the pending transaction.”
11. Why should a third party accept a certificate of trust?

- a. “Any person who acts in reliance on a certificate of trust without knowledge that the representations contained in the certification are incorrect is not liable to any person for so acting and may assume without inquiry the existence of the facts contained in the certification. Knowledge of the terms of the trust may not be inferred solely from the fact that a copy of all or part of the trust instrument is held by the person relying on the certification.” SDCL § 55-4-53.
- b. “Any person who in good faith enters into a transaction in reliance on a certificate of trust may enforce the transaction against the trust property as if the representations contained in the certification were correct.” SDCL § 55-4-54.
- c. “Any person making a demand for the trust instrument in addition to a certificate of trust or excerpts is liable for damages if the court determines that the person did not act in good faith in demanding the trust instrument.” SDCL § 55-4-55.
- d. “The provisions of §§ 55-4-51 to 55-4-55, inclusive, do not limit the right of a person to obtain a copy of the trust instrument in a judicial proceeding concerning the trust.” SDCL § 55-4-56.

### **C. Interested Parties**

1. A trust will commonly include other interested parties to help with the administration of the trust, including for example, a trust protector, trust advisor, investment advisor, investment committee, distribution committee, and other fiduciaries.
2. If not expressly provided in the trust instrument that an interested party may receive a copy of the trust instrument, it is implied by SDCL § 55-1A-38 that a trustee may provide an interested party with the relevant trust information and a copy of the trust instrument in order for the interested party to have the information needed to exercise its powers. The directed trust statutes under Chapter 55-1B also imply the ability for such interested parties to receive a copy of the trust instrument and pertinent trust information.

## **IV. The “Monet” Factors - From Far Away it Looks Like a Clear Picture**

### **A. Closer Look at SDCL § 55-2-13**

1. From far away, SDCL § 55-2-13 appears to provide all of the answers as to which beneficiaries are entitled to a copy of the trust instrument and

when, but up close, it is not as clear. There are some major issues that cause heartburn for all parties involved.

2. SDCL § 55-2-13 sets forth that “the term, qualified beneficiary, means a beneficiary who is twenty-one years of age.”
  - a. This excludes beneficiaries who are under the age of twenty-one.
  - b. There is no exception that authorizes a trustee to provide a copy of the trust instrument to the natural guardian or legal guardian or conservator of a beneficiary.
  - c. Within the narrow confines of SDCL § 55-2-13, this statute leaves a parent or a legal guardian/conservator without the ability to obtain information to protect the interest of a minor or an incapacitated person.
3. SDCL § 55-2-13 may be used inconsistently with other statutes.
  - a. SDCL § 21-22-13 provides for the procedure by which a beneficiary can seek an accounting or other special report from the trustee. SDCL § 21-22-1 defines beneficiary as “any person *in any manner interested* in the trust”. SDCL § 21-22-18 provides that notice of any filings must be given to *all* beneficiaries. Title 21, Chapter 22 has a very broad definition of beneficiary. There is no exception not allowing a trustee to provide trust information to minors or to beneficiaries between the age of eighteen and twenty-one.
    - i. SDCL § 21-22-3 (amended in 2010 by the South Dakota Legislature) sets forth that (with additions shown in highlights and deletions shown as lines):

Within thirty days after entering upon his **or her** duties, any trustee under a court trust shall, if a resident of this state or if any of the trust estate has its situs in this state, file in the office of the clerk of the circuit court of the county specified in § 21-22-5 an inventory of all the trust estate, ~~a duly certified copy of the court order establishing or confirming the trust~~ **a copy of the personal representative's instrument of distribution, a copy of any recorded personal representative's deed of distribution, a duly certified copy of any other court order or clerk's statement establishing or confirming the trust,** a certified copy of the original instrument, if any, on which the trust is based, a statement showing the

names, residences and post office addresses of all persons, including conservators or other trustees interested in the trust, so far as known to the trustee, and the ages of such of them as are minors. Such inventory shall show a list and description of all the trust property, an estimate by the trustee of the value of each item, the encumbrances, if any, on each item, and all claims against the trust estate with the amount of each claim and the name and post office address of the claimant. Such inventory and such statement shall be duly verified by the trustee.

- ii. Despite the inclusiveness of beneficiaries under the age of twenty-one under of Title 21, Chapter 22, the law under SDCL § 55-2-13 could be utilized as authority for a trustee to not provide trust information to a beneficiary under the age of twenty-one.

## **V. Considerations when Providing Trust Information**

### **A. Informed Consent, Ratification or Release of Liability**

1. In situations where a beneficiary must consent, ratify or provide a release of liability, it may be necessary that the beneficiary be provided with more than just a copy of the trust instrument in order for the beneficiary's decision to be valid. Specifically, the beneficiary must be sufficiently informed of material facts surrounding his or her decision:

“It is not necessary that the trustee inform the beneficiary of all the details of which the trustee has knowledge; but, because of the strict fiduciary relationship between trustee and beneficiary, a trustee who would rely on a beneficiary's consent, ratification, or release normally has the burden of showing that the beneficiary was sufficiently informed to understand the character of the act or omission and was in a position to reach an informed opinion on the advisability of consenting, ratifying, or granting a release.”  
REST 3d TRUSTS § 97 cmt. (e).

2. In some situations where a beneficiary may not be a “qualified beneficiary” but would need to provide consent, ratification or a release, then it is advisable to provide that beneficiary with a copy of the trust instrument and material trust information in order to make his or her decision valid.

## B. Notice

1. The virtual representation statutes, SDCL §§ 55-3-31 to 55-3-38, provide guidance as to who needs to be provided with notice regarding trust actions.
  - a. SDCL § 55-3-31 states: “Notwithstanding the provisions of §§ 15-6-55(b) and 15-6-17(c), the provisions of this section and §§ 55-3-32 to 55-3-38, inclusive, apply in any proceeding in which all persons interested in an estate or trust are required to be served or their consent is required. For the purposes of this section, the term, an interest in an estate or trust, includes both interests in income and interests in principal. The Department of Social Services shall be served in any matter where an interested party may owe a debt to the department pursuant to § 28-6-23.”
  - b. SDCL § 55-3-32 provides: “If an interest in the estate or trust has been limited as follows, it is not necessary to serve any other person than as provided by this section:
    - (1) In any contingency to the persons who shall compose a certain class upon the happening of a future event, then on the persons in being who would constitute the class if such event had happened immediately before the commencement of the proceeding;
    - (2) To a person who is a party to the proceeding and the same interest has been further limited upon the happening of a future event to a class of persons described in terms of their relationship to such party, then on the party to the proceeding;
    - (3) To unborn or unascertained persons, none of such persons, but if it appears that there is no person in being or ascertained, having the same interest, the court shall appoint a guardian ad litem to represent or protect the persons who eventually may become entitled to the interest.
  - c. SDCL § 55-3-33 provides: “If an interest in an estate or trust has been limited to a person who is a party to the proceeding and the

If a party to the proceeding has a power of appointment, it is not necessary to serve the potential appointees and, if it is a general power of appointment, it is not necessary to serve the takers in default of the exercise thereof.

same interest has been further limited upon the happening of a future event to any other person, it is not necessary to serve such other person.

- d. SDCL § 55-3-34 provides: “In a proceeding for probate of testamentary instrument, the interests of the respective persons specified in § 55-3-32(2) and § 55-3-33 shall be deemed to be the same interest, whether or not their respective interests are in income or in principal or in both, if they are beneficiaries of the same trust or fund, if they have a common interest in proving or disproving the instrument offered for probate, and if the person who is a party under § 55-3-32(2) or the person to whom the interest has been limited under § 55-3-33 would not receive greater financial benefit if such instrument were denied probate (in the case where such beneficiaries have a common interest in proving such instrument) or admitted to probate (in the case where such beneficiaries have a common interest in disproving such instrument).”
- e. SDCL § 55-3-35 states: “If a party to the proceeding has the same interest as a person under disability, it is not necessary to serve the person under a disability. If there is no party to the proceeding who has the same interest as a person under disability, notice shall be served on that person's conservator, if a conservator has been appointed. If the person under disability is a minor and no conservator has been appointed, notice shall be served on a guardian of the minor if one has been appointed, or if no guardian has been appointed, then on the natural parents, or if there are no natural parents alive, then upon the adoptive parent or parents of the minor. If there are no adoptive parents of a minor, then notice shall be served upon any person responsible for or who has assumed responsibility for the minor's care or custody. If the person under a disability is an adult and no conservator has been appointed, notice shall be served on an agent under a durable power of attorney, a guardian of the adult person, a trustee responsible for the management of all or a portion of the adult person's estate, or any person responsible for or who has assumed responsibility for the adult person's care or custody.”
- f. SDCL § 55-3-38 provides: “Unless the instrument expressly provides otherwise, if the consent of all beneficiaries of a trust or estate is required for the approval of any action, modification, or termination of such trust or estate, the consent of all beneficiaries upon whom service of process would be required in a judicial proceeding for approval of such action, modification, or termination shall be binding and conclusive upon all persons upon whom service would not be required under §§ 55-3-31 to 55-3-37,

inclusive, and this section to the same extent as the approval of the action, modification, or termination binds the persons who were served or would have been served for the judicial approval of such action, modification, or termination.”

2. In the United States the doctrine of virtual representation has its origins between 1860 and 1940 as a jurisdictional concept. It was, and still is, in most jurisdictions described as “a method of acquiring jurisdiction over minors, unborns, and persons under a disability without making such persons parties to the proceeding, yet binding the represented persons to the result.” Begleiter, Martin, *Serve the Cheerleader—Serve the World: An Analysis of Representation in estate and Trust Proceedings and Under the Uniform Trust Code and Other Modern Trust Codes*, 43 Real Proper. Tr. & Est. L.J. 311, p. 5, Real Property, Trust and Estate Law Journal, Summer 2008, p. 27
3. As a prerequisite to the effectuation of administrative convenience for the trustee, the doctrine of virtual representation requires that there is a commonality of interests. However, how does a beneficiary of whom virtual representation is being applied know there is commonality of interests without being provided the relevant information? Inherent conflicts may exist between the various beneficiaries. Although many jurisdictions have virtual representation statutes, it is prudent for a trustee to question the adequacy of the representation that can be provided if virtual representation is utilized. Likewise, the attorney for a beneficiary of whom virtual representation is being applied should pay attention to the adequacy of the representation.
  - a. As an example, In the Matter of Will of Maxwell, 704 A.2d 49 (N.J. Super. A.D. 1997), the court stated that the “[p]arents, who were life beneficiaries of trust, could not represent their minor children’s interests in trust accountings. since clear conflict of interest existed[.]” 704 A.2d at 58-59. The court determined the relationship between potential remainderpersons was “not sufficiently close to guarantee identity of interests.” 704 A.2d at 58.

## **VI. Ethical Considerations for Attorneys**

### **A. Capacity Issues - Who may be provided with trust information when the beneficiary is incapacitated?**

1. An attorney or other advisor working with an elderly or disabled client may have to face the issue of the client’s incapacity. Unfortunately, there is little guidance for attorneys dealing with clients who become incapacitated.

2. Rule of Professional Conduct 1.6 provides:

- (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent except for disclosures that are impliedly authorized in order to carry out the representation or the disclosure is permitted by, and except as stated in paragraph (b).
- (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
  - (1) to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm;
  - (2) to secure legal advice about the lawyer's compliance with these Rules;
  - (3) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;
  - (4) to the extent that revelation appears to be necessary to rectify the consequences of a client's criminal or fraudulent act in which the lawyer's services had been used; or
  - (5) to comply with other law or a court order.

3. Rule of Professional Conduct 1.14 provides:

- (a) When a client's capacity to make adequately considered decisions in connection with a representation is diminished, whether because of minority, mental impairment or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client.
- (b) When the lawyer reasonably believes that the client has diminished capacity, is at risk of substantial physical, financial or other harm unless action is taken and cannot



adequately act in the client's own interest, the lawyer may take reasonably necessary protective action, including consulting with individuals or entities that have the ability to take action to protect the client and, in appropriate cases, seeking the appointment of a guardian ad litem, conservator or guardian.

(c) Information relating to the representation of a client with diminished capacity is protected by Rule 1.6. When taking protective action pursuant to paragraph (b), the lawyer is impliedly authorized under Rule 1.6(a) to reveal information about the client, but only to the extent reasonably necessary to protect the client's interests.

4. If a client has diminished capacity but shows that he or she can comprehend the need for planning and knows what he or she wants to do, then enlisting a trusted family member or advisor to assist may be desirable. However, permitting a third party to be present creates problems with confidentiality; thus, the client should sign a waiver of confidentiality that permits the third party to be present and authorizes the disclosure of information to such person.
5. Under the Rules, if a client is truly incompetent, an attorney may take protective action for his or her client such as to seek the appointment of a guardian.

## VII. Drafting Considerations

### A. Protecting Confidentiality and Privacy

1. Adding provisions to trust agreement to avoid the necessity of providing third parties a copy of the entire trust is recommended. An example is as follows:

**Third Parties' Right to Information.** The Trustee may furnish a Certificate of Trust to any person dealing with this Trust (hereinafter referred to as a "third party") who requests such Certificate or copy of the Trust Instrument. The third party shall be entitled to rely on a Certificate of Trust furnished to such third party and prepared in accordance with SDCL § 55-4-51. The Trustee may further provide a copy of those portions of the Trust Instrument to a third party, including the powers of trustee section and signature pages, if the Trustee believes, in Trustee's sole discretion, such third party is in need of such portions. The third party shall incur no liability to the Trust, Grantor, Trustee or any beneficiary hereunder for relying upon the representations set forth

in the Certificate of Trust or such portions of the Trust Instrument and acting pursuant to those terms, and shall not be required to see to the disposition of the Trust proceeds or the discharge of the Trustee's duties hereunder. In no event shall the Trustee provide to a third party the portion of the Trust Instrument setting forth the dispersal of income and principal, except as the Trustee deems advisable, in Trustee's sole discretion.

2. Estate planners should consider drafting around statutes that do not reflect the grantor's desires. For example, if the grantor desires a grandchild who is a minor to be able to receive a copy of the trust instrument and notice of trust actions then language should be included to nullify the qualified beneficiary statute (SDCL § 55-2-13) and virtual representation statutes (SDCL §§ 55-3-31 to 55-3-38). Another example of where an estate planner could use specific language to draft around statutes would be where a grantor desires remainder beneficiaries to receive accountings. These are issues that an estate planner should consider discussing with clients who desire beneficiaries to receive more information than otherwise allowed under codified law.
3. Another option for estate planners to consider is making the election of having the trust be governed by the laws of another state if that state has laws that conform with the desires of the grantor. However, unfamiliarity with other state statutes and case precedent may have unintended consequences and should be used with caution.

## **VIII. Comparison of State Laws**

### **A. Leading The Way – Alaska, Delaware, Nevada and South Dakota**

1. *Trust & Estates* magazine ranked the top four trust states for 2010 as South Dakota, Delaware, Alaska and Nevada. South Dakota has some room for improvement when comparing the laws of the leading states in trust law.
2. In comparing the top four trust states, all four states use the substitution of a trust instrument with a certificate of trust to persons other than a beneficiary. Nevada, however, provides that a trustee may present a certification of trust to any person, in lieu of a copy of any trust instrument. South Dakota stands alone with its definition of qualified beneficiary as it is the only state that prohibits a copy of the trust to be given to a person under the age of twenty-one, and arguably, to a person who is incapacitated.
3. Below is a comparison of the top four trust states' statutes that specifically pertain to providing trust information.

- a. Alaska:
  - i. AS § 13.36.079 provides:
    - (a) Except as otherwise provided in the trust instrument, instead of furnishing a copy of the trust instrument to a person other than a beneficiary, the trustee may furnish to the person a certification of trust containing the following information:
      - (1) that the trust exists and the date the trust instrument was executed;
      - (2) the identity of the settlor;
      - (3) the identity and address of the currently acting trustee;
      - (4) the powers of the trustee;
      - (5) the revocability or irrevocability of the trust and the identity of any person holding a power to revoke the trust;
      - (6) the authority of co-trustees to sign or otherwise authenticate documents related to the trust and whether all or fewer than all co-trustees are required to exercise the trustee powers;
      - (7) the trust's taxpayer identification number, if the trust has a taxpayer identification number; and
      - (8) the manner of taking title to the property of the trust.
    - (b) A certification of trust may be signed or otherwise authenticated by any trustee.
    - (c) A certification of trust must state that the trust has not been revoked, modified, or amended in a manner that would cause the

representations contained in the certification of trust to be incorrect.

- (d) A certification of trust is not required to contain the dispositive terms of a trust.
- (e) A recipient of a certification of trust may require the trustee to furnish copies of the excerpts from the original trust instrument, including amendments to the trust that designate the trustee and confer on the trustee the power to act in the pending transaction for which the certification of trust is being furnished.
- (f) A person who acts in reasonable reliance on a certification of trust without knowledge that the representations contained in the certification of trust are incorrect is not liable to another person for acting in reasonable reliance on the certification of trust and may assume without inquiry the existence of the facts contained in the certification. Knowledge of the terms of the trust may not be inferred solely because the person relying on the certification is holding a copy of part of the trust instrument.
- (g) A person who in good faith enters into a transaction in reasonable reliance on a certification of trust may enforce the transaction against the trust property as if the representations contained in the certification were correct.
- (h) A person making a demand for the trust instrument in addition to a certification of trust or excerpts from the trust instrument is liable to the state for a civil penalty not to exceed \$1,000, plus the actual damages associated with the demand for the trust instrument, if a court determines that the person did not act in good faith in demanding the trust instrument.
- (i) A person who is found liable for a civil penalty under (h) of this section shall also be

liable for actual court costs and attorney fees associated with a demand made under (h) of this section.

- (j) This section does not limit the right of a person to obtain a copy of the trust instrument in a judicial proceeding concerning the trust.

ii. A.S. § 13.36.390

“qualified beneficiary” means a beneficiary who:

- (A) on the date the beneficiary's qualification is determined, is entitled or eligible to receive a distribution of trust income or principal; or
- (B) would be entitled to receive a distribution of trust income or principal if the event causing the trust's termination occurs;

b. Delaware:

i. 12 Del.C. § 3591 provides:

- (a) Instead of providing a person other than a beneficiary with a copy of the trust instrument, a trustee may provide the person with a certification of trust containing statements concerning, but not limited to, the following matters:
  - (1) The existence of the trust and the date of execution of the trust instrument;
  - (2) The identity of the trustor or trustors and of the currently acting trustee or trustees of the trust;
  - (3) The powers of the trustee;
  - (4) The revocability or irrevocability of the trust and the identity of any person holding a power to revoke the trust;

- (5) The authority of co-trustees to sign and whether all or less than all are required to sign in order to exercise powers of the trustee;
  - (6) The trust's taxpayer identification number; and
  - (7) The manner in which title to trust property may be taken.
- (b) A certification of trust must be in the form of an acknowledged writing and may be signed by any trustee.
  - (c) A certification of trust must contain a statement that the trust has not been revoked, modified or amended in any manner that would cause the representations contained in the certification of trust to be incorrect.
  - (d) A certification of trust need not contain the dispositive terms of a trust.
  - (e) A recipient of a certification of trust may require the trustee to provide copies of those excerpts from the original trust instrument and later amendments which designate the trustee and confer upon the trustee the power to act in the pending transaction.
  - (f) A person who acts in reliance upon a certification of trust without knowledge that the representations contained therein are incorrect is not liable to any person for so acting and may assume without inquiry the existence of the facts contained in the certification. Knowledge of the terms of the trust may not be inferred solely from the fact that a copy of all or part of the trust instrument is held by the person relying upon the certification.
  - (g) A person who in good faith enters into a transaction in reliance upon a certification of trust may enforce the transaction against the

trust property as if the representations contained in the certification were correct.

- (h) A person making a demand for the trust instrument in addition to a certification of trust or excerpts is liable for damages, including attorney's fees, if the court determines that the person did not act in good faith in requesting the trust instrument.
- (i) This section does not limit the right of a person to obtain a copy of the trust instrument in a judicial proceeding concerning the trust.

ii. F12 Del.C. § 3819 provides:

- (a) Except to the extent otherwise provided in the governing instrument of a statutory trust, each beneficial owner of a statutory trust has the right, subject to such reasonable standards (including standards governing what information and documents are to be furnished at what time and location and at whose expense) as may be established by the trustees, to obtain from the statutory trust from time to time upon reasonable demand for any purpose reasonably related to the beneficial owner's interest as a beneficial owner of the statutory trust:
  - (1) A copy of the governing instrument and certificate of trust and all amendments thereto, together with copies of any written powers of attorney pursuant to which the governing instrument and any certificate and any amendments thereto have been executed;
  - (2) A current list of the name and last known business, residence or mailing address of each beneficial owner and trustee;
  - (3) Information regarding the business and financial condition of the statutory trust; and
  - (4) Other information regarding the affairs of the statutory trust as is just and reasonable.

- (b) Except to the extent otherwise provided in the governing instrument of a statutory trust, each trustee shall have the right to examine all the information described in subsection (a) of this section for any purpose reasonably related to the trustee's position as a trustee.
- (c) Except to the extent otherwise provided in the governing instrument of a statutory trust, the trustees of a statutory trust shall have the right to keep confidential from the beneficial owners, for such period of time as the trustees deem reasonable, any information that the trustees reasonably believe to be in the nature of trade secrets or other information, the disclosure of which the trustees in good faith believe is not in the best interest of the statutory trust or could damage the statutory trust or its business or which the statutory trust is required by law or by agreement with a third party to keep confidential.
- (d) A statutory trust may maintain its records in other than a written form if such form is capable of conversion into a written form within a reasonable time.
- (e) Any demand by a beneficial owner or trustee under this section shall be in writing and shall state the purpose of such demand.

c. Nevada:

- i. N.R.S. 164.400 provides:
  - 1. Except in connection with an application for benefits pursuant to chapter 422 or 422A of NRS, a trustee may present a certification of trust to any person, in lieu of a copy of any trust instrument, to establish the existence or terms of the trust. The trustee may present the certification voluntarily or at the request of the person with whom he is dealing.
  - 2. Such a certification must be in the form of an affidavit signed and acknowledged by all of the currently acting trustees of the trust.



ii. N.R.S. 164.420 provides:

A certification of trust need not contain the dispositive provisions of the trust, but the person to whom the certification is presented may require copies of excerpts from any trust instrument which designate the trustee or confer upon him the power to act in the pending transaction.

iii. N.R.S. 164.430 provides:

1. A person who acts in reliance upon a certification of trust without knowledge that the representations contained therein are incorrect is not liable to any person for so acting. A person who does not know that the facts contained in the certification are incorrect may assume without inquiry the existence of the facts contained in the certification. Knowledge may not be inferred solely from the fact that a copy of all or part of a trust instrument is held by the person relying upon the certification.
2. A transaction, and any lien created thereby, entered into by a trustee and a person acting in reliance upon a certification of trust is fully enforceable against the assets of the trust unless the person knows that the trustee is acting outside the scope of the trust.

**B. Suggestions for South Dakota to Improve**

1. Should the gap in SDCL § 55-2-13 be closed so that natural guardians or legal guardians/conservators may receive the trust information on behalf of the minor or protected person?
2. For uniformity purposes with other laws, should the requirement of a beneficiary being the age of twenty-one be reduced to the age of majority?
3. For uniformity purposes between SDCL § 55-2-13 and SDCL § 55-4-51, should a certificate of trust could be given to a person other than a “qualified” beneficiary since other beneficiaries are not entitled to a copy of the trust instrument?
4. Should SDCL § 55-2-13 address how a qualified beneficiary of a trust that existed before 2002 obtain a copy of the trust since said statute eliminates any common law duty or other duty to notify of the trust’s existence?

5. Should a statute specifically authorize a trustee to give trust information to interested parties that may have a fiduciary or other professional relationship with a trust?

# Observations on the Current Status of the Federal Estate Tax

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## I. INTRODUCTION

- A. **Disclaimer.** The comments made in the following materials and presentation do not represent a complete summary or analysis of the issues surrounding the impact of the Economic Growth and Tax Relief Act of 2001, P.L. 107-16 (“EGTRRA”) with respect to repeal the federal estate tax and the federal generation skipping tax for 2010 and the reinstatement of the federal estate tax and the federal generation skipping tax in 2011. Rather the enclosed material consists of highlights of several of the more significant issues resulting from the repeal and the outlook (speculative) on future Congressional action on the federal estate tax. Unless specifically stated, the thoughts, opinions and perspectives contained in this material and presentation are those of the presenter and should not be imputed to any other party.

These materials were prepared in mid to late May and very early June, 2010. Actions in Washington or the general news occurring after these materials have been submitted for inclusion in the program materials may have a significant impact upon the contents, and especially upon comments and speculations relating to the possibility of Congressional action on the federal estate tax.

- B. **What Happened?** In 2001 Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”). The Act made a number of changes to the federal estate, gift and generation skipping tax law as it existed at that time and repealed the federal estate tax and the federal generation skipping tax entirely for persons dying after January 1, 2010 and before January 1, 2011. For persons dying after December 31, 2010 the Act reinstated the federal estate and generating skipping laws as in effect in 2001.

During the years 2001 through 2009 “everyone” anticipated that Congress would take some action to avoid the repeal of the estate and generation skipping taxes. As late as December, 2009 there was a widespread assumption that Congress would extend the estate and generation skipping tax in effect in 2009 for the year 2010.

However, Congress failed to act and the provisions of EGTRRA repealing the estate and generation skipping taxes for 2010 became effective. A modified carryover basis regime also became effective.

- C. **How Did This Happen?** The cause behind the failure of Congress to act to extend the 2009 law into 2010 is speculative. Each commentator, pundit and observer has his or her own opinion. Most likely there is no single cause. The political environment in which Congress was operating in December, 2009 was a complex mix of influences most of which had little direct relationship to or concern for the federal estate tax.

It should be noted many of the factors present in December 2009 remain fully alive and well. These same factors are likely to affect the action of Congress during 2010 with respect to the adoption of a new federal estate tax or the inaction of Congress to allow the reinstatement of the federal estate tax as it existed in 2001 as called for under the existing statute.

## **II. Current Status**

### **A. Exemption and Rates—a Comparison: 2009, 2010, 2011.**

<u>Estate Tax</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Exemption	3,500,000	Unlimited	\$1,000,000
1,000,000-1,250,000	na	na	41%
1,250,000-1,500,000	na	na	43%
1,500,000-2,000,000	na	na	45%
2,000,000-2,500,000	na	na	49%
2,500,000-3,000,000	na	na	53%
3,000,000-3,500,000	na	na	55%
3,500,000-10,000,000	45%	na	55%
10,000,000-17,184,000	45%	na	60%
17,184,000 and above	45%	na	55%

<u>Gift Tax</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Exemption	1,000,000	Unlimited	\$1,000,000
1,000,000-1,250,000	41%	35%	41%
1,250,000-1,500,000	43%	35%	43%
1,500,000-2,000,000	45%	35%	45%
2,000,000-2,500,000	45%	35%	49%
2,500,000-3,000,000	45%	35%	53%
3,000,000-3,500,000	45%	35%	55%
3,500,000-10,000,000	45%	35%	55%
10,000,000-17,184,000	45%	35%	60%
17,184,000 and above	45%	35%	55%

<u>Generation Skipping Tax</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Exemption	3,500,000	Unlimited	\$1,000,000*
1,000,000-3,500,000	na	na	55%
3,500,000-and above	45%	na	55%

\*The GST tax exemption is indexed for inflation occurring after 1999.

### **B. South Dakota Statistics.** According to statistics released by the IRS for the filing year 2009, there were 94 estate tax returns filed for South Dakota decedents

reporting a cumulative total of approximately \$384,272,000 in the gross estates. Of the returns filed, 15 estates incurred a federal estate tax and a total of \$26,640,000 in estate tax was due from all estates.

The same statistics released for the filing year 2001 show a total of 354 estate tax returns were filed for South Dakota decedents reporting a total of approximately \$683,580,000 for the gross estates of all returns filed. Of that number 163 estates incurred a total federal estate tax liability of approximately \$41,857,000.

### III. NEW LEGISLATION—RETROACTIVITY

- A. **Background.** The United States Supreme Court has recognized the existence of an economic due process right under the due process clause of the Fifth Amendment. *United States v. Carlton*, 512 U.S. 26, 30-31 (1994), citing *Pension Benefit Guaranty Corporation v. R.A. Gray & Co.*, 467 U.S. 717, 729-30 (1984).

However retroactive tax legislation has been found valid if the legislation has "... a legitimate legislative purpose and does not apply to an 'excessive' period of time." *Ibid.*

A period of fourteen months was not considered excessive in the *Carlton* case cited above which considered an amendment to Section 2057 concerning an estate tax deduction for a portion of the proceeds of a sale of employer securities to an employee stock ownership plan.

An eight month retroactive increase in the rate of the estate tax from 50% to 55% was upheld in *NationsBank of Texas, N.A., v. United States*, 269 F.3d 1332, 1228 (Fed Cir. 2001).

See also *Kane v. U.S.*, 18 F.3d 1576 (3<sup>rd</sup> Cir. 1997).

A statement of the current law along with a sense of the prevailing judicial perspective is shown in the following quotations:

From: *Quarty v. United States*, 170 F.3d 961, 961 (9<sup>th</sup> Cir. 1999);

The Supreme Court ... repeatedly has upheld retroactive tax legislation against a due process challenge. The Court has noted on numerous occasions that Congress "almost without exception" has given general revenue statutes effective dates prior to the dates of actual enactment." This "customary congressional practice" generally has been "confined to short and limited periods required by the practicalities of producing national legislation," and the Court is "loathe to reject such a common practice when conducting the limited judicial review accorded economic legislation under the Fifth Amendment's Due Process Clause."

and

That standard is whether retroactive application itself serves a legitimate purpose by rational means:

Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches ... To be sure, ... retroactive legislation does have to meet a burden not faced by legislation that has only future effects ...“The retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former”... But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose.

*(citations omitted.)*

From *Wiggins V. Commissioner*, 904 F.2d 311, 314 (5<sup>th</sup> Cir. 1990).

Tax statutes have often been applied retroactively to transactions that occurred during limited periods prior to enactment, without violating the due process clauses of the Constitution. In each case a court should consider the nature of the tax and the circumstances of its application to determine whether "its retroactive application is so harsh and oppressive" that it violates due process. Retroactive application has been held unconstitutional only in situations in which a statute imposed a wholly new tax, which could not reasonably have been anticipated by the taxpayer at the time of the transaction. *(citations omitted.)*

- B. **Uncertainty for current decedents.** Irrespective of the prior case law, the likelihood of a constitutional challenge to a retroactive effective date for a new federal estate tax seems high. The length of time for such case to work its way through the judicial process will be significant. Thus the status of such retroactive legislation for decedents dying prior to the date of enactment will remain uncertain for a substantial period of time.

#### **IV. WHERE IS ATTENTION NEEDED—SEVERAL MAJOR ISSUES**

- A. **Formula Clauses and Tax Related Terms—Definitional Matters.** One of the primary effects of the lapse of the federal estate tax and generation skipping tax is the effect upon “formula” language in existing wills, trusts or other documents. Many documents contain language which reference terms, concepts or specific sections contained in the Internal Revenue Code (the “Code”).

Some examples of terms frequently used include “marital deduction,” “unified credit against estate tax,” “applicable exemption amount,” “applicable

credit amount,” “gross estate,” “taxable estate,” “generation skipping transfer tax exemption,” “GST exemption” etc.

Such language is most typically used in connection with determination of a marital or charitable bequest, or in connection with assets passing to a second generation younger than the testator.

The question arises whether such terms have any legally definable meaning in light of the lapse of the federal estate tax.

Some states, including South Dakota, have enacted legislation designed to provide the definitions of such terms or formulas using such terms by reference to the federal estate tax as it existed prior to January 1, 2010.

The South Dakota legislature passed House Bill 1201 during the 2010 legislative session which is intended to provide a definition for such terms. The bill was passed by the Senate and signed by Governor Rounds on March 11, 2010. The Act provides a list a terms which, if used in a will or trust of a decedent who dies during 2010, shall have the same meaning as applied to estates of decedents dying on December 31, 2009.

The Act does not apply to a will or trust executed or amended after December 31, 2009 or which manifests a contrary intent A copy of the bill is included as an Appendix to these materials.

A Practice Alert issued by Research Institute of America’s Checkpoint tax service about June 1, 2010 lists eight states (NOT including South Dakota) as having enacted similar statutes.

- B. Planning Documents for Tax/No Tax Situations.** Many clients may plan their estate allocation and distribution very differently depending upon whether there is or is not a federal estate tax. This will be particularly true for persons with estates larger than one million dollars but less than \$3.5 or \$5 million depending upon where, if any, estate tax exemption may settle.

As a result of client desires and the uncertainty of dates of death and Congressional action on the federal estate tax, it may be appropriate for documents to include alternative provisions depending upon whether a federal estate tax has been passed and the amount of the exemption included in any such legislation.

A particular estate plan may, in fact, have multiple alternatives to give consideration to the existence of the estate tax, the size of the exemption and the size of the estate. Such contingencies may also be particularly relevant in situations involving a surviving spouse who is not the parent of the testator’s children.



It seems two non-tax issues will also present difficulties for the practitioner in such situations: the tolerance or lack of tolerance of clients for “complexity” in the estate plan and planning documents; and the tolerance or lack of tolerance of clients for the costs of legal services associated with planning and drafting for multiple contingencies.

- C. **South Dakota Estate Tax and the State Death Tax Credit.** In 2000 South Dakota adopted an amendment to the state Constitution outlawing tax on any “inheritance” and thus invalidated the South Dakota Inheritance Tax. South Dakota Constitution Article XI, §15. However, the statutory sections relating to the South Dakota Inheritance Tax have not been repealed and continue in SDCL 10-40 and 10-41. The South Dakota Inheritance Tax is contemplated by such chapters, however is not collected.

Separate from the South Dakota Inheritance Tax, however South Dakota still has an estate tax as part of the statute in SDCL 10-40A. The South Dakota Estate Tax is applicable in an amount equal to the state death tax credit allowable with respect to the federal estate tax. The South Dakota Estate Tax however slowly effectively expired as the state death tax credit permitted against the federal estate tax was reduced under EGTRRA.

Obviously in 2010 the South Dakota Estate Tax is a non-issue. However in 2011, if resurrection of the federal estate tax law as it existed in 2001 comes to pass, the state death tax credit will again be effective and South Dakota may again generate revenue from the state estate tax.

- D. **Making current gifts and generation skipping transfers.** Within estate planning literature some authors advocate making taxable gift tax transfers during 2010 to take advantage of the current 35% gift tax rate and/or making generation skipping transfers during 2010 to take advantage of the repeal of the GST tax.

If there is truly a decreased likelihood of a retroactive enactment of the federal estate tax, such transactions have an appeal and the possibility of significant tax savings. However such transactions are not for the faint of heart and should be considered only after careful study of the potential ramifications. Materials such as those cited at the end of this outline or other professional literature should be consulted, careful thought given and candid discussion (and probably careful written documentation of the discussions) with the client held before proceeding upon such a course.

## V. CARRYOVER BASIS

- A. **Carryover Basis—New Basic Rule.** Under the tax laws prior to 2010 the beneficiaries receiving assets passing from a decedent take a basis for computing gain or loss equal to the fair market value of the assets on the date of the

decedent's death. Section 1014. The basis adjustment would normally increase the asset's basis to eliminate tax upon the gain resulting from appreciation of the asset which occurred between the date of the acquisition of the asset by the decedent and the date of the decedent's death. The basis adjustment could also *decrease* the basis of the asset if the decedent's basis in the asset on the date of the decedent's death was greater than the fair market value of the asset.

Under the law in effect in 2010, the old "step up" basis rules are no longer applicable. Under Section 1022 the basis of property acquired from a decedent after December 31, 2009 is the decedent's basis unless the fair market value of the property is less than the decedent's basis, in which case the basis will be reduced to the fair market value of the property.

**B. Carryover Basis—Special Adjustment.** The basis of property received from a decedent after December 31, 2009 may be increased by an adjustment provided by Section 1022(b). The amount of the permitted increase is the sum of:

- (1) \$1,300,000; plus
- (2) The amount of the decedent's unused capital loss carryovers under Section 1212(b); plus
- (3) The amount of the decedent's unused net operating loss carryovers under Section 172; plus
- (4) The amount of any losses which would have been recognized if an asset had been sold by the decedent immediately prior to his or her death.

No adjustment is permitted which would increase the basis of any asset in excess of its fair market value.

**C. Carryover Basis—Spousal Adjustment.** A second adjustment is provided by Section 1022(c). The adjustment may be made only to property received by from a decedent by a surviving spouse. The amount of the adjustment is \$3,000,000.

In order to qualify for the spousal adjustment to basis, the property received by the surviving spouse must be either transferred outright to the surviving spouse or consist of "qualified terminable interest property" as defined in Section 1022(c)(5). The definition is substantially similar to the definition of qualifying terminable interest property ("QTIP") in Section 2056 relating to the marital deduction.

The \$3,000,000 figure refers to the amount of the increase to basis allowed, not to the fair market value of the property received by the surviving spouse.

No adjustment is permitted which would increase the basis of any asset in excess of its fair market value.

- D. **Carryover Basis—Inflation.** The carryover basis adjustment figures of \$1,300,000 and \$3,000,000 are to be adjusted annually for inflation, however the adjustment is to be rounded to \$100,000 for the \$1,300,000 amount and \$250,000 for the \$3,000,000 amount.
- E. **Carryover Basis—Allocation and Reporting.** The reporting requirements for the basis adjustment under section 1022 are set forth in Section 6018 and include the following.
- (1) Allocation of the basis adjustment is to be made by the Personal Representative. Note the allocation may be made to assets not part of the “probate estate” and not subject to direct control of the Personal Representative.
  - (2) If a Personal Representative does not have complete information with respect to any property the Personal Representative may file the return with as much information as is available and a trustee or beneficiary may file a return with additional information. Some commentators have questioned whether a Trustee (such as of a revocable trust) may have the authority to make the election if no Personal Representative is appointed.
  - (3) The return required for allocating the basis adjustment is made pursuant to Section 6018 and requires the following information:
    - a. Name and TIN of recipient;
    - b. An accurate description of the property;
    - c. The adjusted basis of the property in the hands of the decedent and its fair market value at the time of the decedent’s death;
    - d. The decedent’s holding period for such property;
    - e. Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;
    - f. The amount of basis increase allocated to the property under subsection 1022(b) or (c);
    - g. Other information required by the Secretary.
  - (4) The Personal Representative must furnish a statement to each beneficiary of property passing from a decedent for which a basis adjustment is made, containing:
    - a. The name address, and telephone number of the person making the return;

- b. The information shown on the return with respect to each item of property for which a basis adjustment is made.
  - c. The statements to the beneficiaries must be provided within 30 days of the Personal Representative filing the return allocating the basis adjustments.
- E. **Special Rules Regarding Ownership.** Special rules regarding the basis adjustments discussed above apply for jointly held property, revocable trusts, powers of appointment and community property. In addition a special rule prohibits a basis adjustment to property acquired by the decedent by gift within three years of death.
- F. **Some Planning Considerations.** Several planning considerations arise as a result of the carryover basis adjustment options. Some, but by no means all, include:
  - (1) Significant information will have to be gathered with respect to assets passing from a decedent. The amount of required information is greater than the information required for the Federal Estate Tax Return, Form 706, and may be more difficult to obtain.
  - (2) It is not clear what fiduciary responsibility or liability a Personal Representative may have with respect to basis allocation. Particular concerns may arise when the Personal Representative is also a beneficiary.
  - (3) Efforts and costs to appraise property and create and keep records by estates which were not required to file an Estate Tax Return prior to 2010 have substantially increased. The appraisal and record keeping activities will be required regardless of the size of the former “gross estate.” Failure to prepare and maintain the necessary information will, at the least, create greater income tax costs to the beneficiaries at the time of the disposition of the property. This will be especially true of “modest” estates.
  - (4) In larger estates changes to asset ownership may be important to insure the full use of both the \$1,300,000 and the \$3,000,000 basis adjustment.
  - (5) Probable future increases in the income tax and the capital gains tax rates make the consequence of basis adjustment issues more significant.
  - (6) Language regarding authority of the Personal Representative to make basis adjustments, and to a trustee of a revocable inter vivos trust to cooperate with respect to basis adjustments, should be considered to be added to or included in documents. Drafting such language however presents challenges for a careful planner. The following language is

suggested by the Fitzgerald-Boyette article cited at the end of the materials. Even a cursory reading of the draft language, however, highlights difficult practical issues when thinking of actual family circumstances and personalities.

My Personal Representative shall have the power to allocate any basis adjustment allowable under Section 1022 of the Internal Revenue Code in any manner in which it deems best. My Personal Representative shall not be required to allocate basis adjustments proportionately or exclusively to all assets passing under this Will, and I waive any such duty that might exist. My Personal Representative shall also have full power and discretion to allocate any such basis adjustment to any one or more assets that my Personal Representative receives by this Will or otherwise, or in which my Personal Representative has a personal interest, to the partial or total exclusion of all other assets with respect to which an election could be made under Section 1022 of the Internal Revenue Code. I recommend that my Personal Representative consider the following objectives in making any decision under this Section \_\_: (a) provision of appropriate investments for the beneficiaries in light of their respective needs for liquidity, income and security; and (b) reduction of the overall gift, estate, and income taxes payable by the beneficiaries and their respective estates. My Personal Representative shall incur no liability for the effect of any decision hereunder and shall make no compensating adjustment therefore [*sic.*].

It appears the foregoing language was probably prepared for use by a corporate Personal Representative or a Personal Representative who is able to evaluate the basis adjustment allocations from a truly neutral position. It is much less clear whether such language is appropriate in a circumstance when the Personal Representative is a beneficiary of the estate or may have major or minor “relationship baggage” with other beneficiaries.

## VI. CONGRESSIONAL RESEARCH SERVICE REPORT FOR CONGRESS

- A. **Report Issued.** On April 23, 2010 the Congressional Research Service issued a report to Congress entitled *Estate Tax Options* (the “Report”). The Report contains a brief description of the estate tax, options for revision, an introduction to issues, a number of tables of data and a conclusion. The following paragraphs contain informative quotations from the Report or a summary of comments or observations about the Report. (In the following sections material quoted from the Report are indicated by italics. All references are to the Report.)

- B. **Report cites “General Agreement.”** *There is general agreement that some sort of estate tax will be retained. A proposal to make the 2009 rules (\$3.5 million exemption and 45% rate) permanent was included in President Obama's 2010 and 2011 budget outlines and was passed by the House in December 2009 (H.R. 4154). Senate Democratic leaders have indicated a plan to enact the 2009 rules permanently (and make them retroactive to 2010). The Senate Republican leadership has proposed a \$5 million exemption and 35% rate.* Summary.
- C. **Report—Few Estates Affected by Tax.** The Report states that "few estates" are affected by the tax. The Report cites 0.25% of estates are affected assuming a \$3.5 million exemption and 0.14% of estates are affected assuming a \$5 million exemption. An estate tax with an exemption level of \$1 million would affect 1.76% of all decedents. Summary.
- D. **Report—Few Small Businesses and Farms Affected.** *Although concerns have been raised about the effects of the tax on small businesses and farmers, estimates indicate that the share of estate taxes paid by small business estates under the proposed revisions would be small (16% to 18%) and the share of estates of small business owners taxed is small (about 0.2% of decedents with at least 50% of their assets in businesses). Evidence suggests that the number of returns with inadequate liquid assets to pay the estate tax is negligible.* Summary.
- E. **Report—Few Small Businesses and Farms Affected.** The Report specifically addresses the effect of the estate tax on small businesses and upon farms and ranches. The Report indicates that the number of farm estates subject to tax would be less than 123 estates at the \$3.5 million exemption and about 65 estates at the \$5 million exemption (2000 figures adjusted for 2011). p.12.
- F. **Report— Few Small Businesses and Farms Illiquid.** The Report further presents data to show, assuming a \$3.5 million exemption, only 13 farms will incur an estate tax with insufficient liquid assets in the estate to pay the tax liability. p.13.
- G. **Report – Assist Small Businesses and Farms Elsewhere.** *Regardless of the data source used, the evidence suggests two important characteristics of businesses and the estate tax: businesses pay a small fraction of the estate tax and a tiny fraction of total estates of businesses and farmers are liable for the tax. If estate tax policy decisions are driven by these concerns, a more target-efficient alternative would be to provide additional benefits for business assets, such as an expanded QFOBOBI [sic.] deduction.* p.13.
- H. **Report—Estate Tax Revenue Small.** The estate tax in 2011 with an exemption of \$1 million and a top rate of 55% would generate a "small share" of federal revenue, estimated at 1.3% of federal revenues for 2011. p.6. The revenue yield in 2011 is projected to be \$34.4 billion assuming a \$1 million exemption and a 55% rate; \$18.1 billion assuming a \$3.5 million exemption

and a 45% rate; and \$11.2 billion assuming a \$5 million exemption and a 35% rate. (It should be noted the Report acknowledges that revenue gain or loss projections made by the staff of the Joint Committee on Taxation and by the staff of the Treasury differ.)

- I. **Report—Estate Tax Paid by Large Estates.** The Report discusses at some length, the concentration of the estate tax upon a very small number of large estates and the highly progressive nature of the estate tax, which increases with exemptions of \$1 million, \$3.5 million and \$5 million respectively. p. 6-9.
- J. **Report—Effective Rate Law.** The Report also discusses the difference between the effective tax rate compared to the nominal rate. The Report finds the effective tax rate upon an estate of \$20 million with an exemption of \$1 million and a top nominal rate of 55% to be 16.5%. p.10.
- K. **Report—Impact Primarily on High Income Taxpayers.** The Report considers the distribution of the estate tax by income class (percentile). With a \$1 million exemption and 55% rate, the top 1 percentile of taxpayers based on income pay 45% of the total estate tax revenue. If the exemption is \$3.5 million and the top rate is 45% then the top 1 percentile of taxpayers based on income pay 72% of the total estate tax revenue. p. 10.
- L. **Possible Law Changes.** The Report considers several design issues connected to a potential newly enacted (or amended "old") estate tax. Several of the design issues discussed include:
  - (1) portability of the spousal exemption, p.17; (comments generally not encouraging);
  - (2) grantor retained annuity trusts, p.17; (changes to the current rules already proposed); and
  - (3) minority discounts, p.17; (supportive of the Administration's proposal amend the Code to disregard certain actions used to create discounts among family members).
- M. **Report—Conclusion.** The Conclusion of the Report consists of four relatively short paragraphs included below verbatim:

*The analysis indicates that the estate tax is relatively small, in revenues, in coverage, and in its effects on family businesses, savings, charitable contributions, and tax administration and compliance. One-fourth of 1% or less of all estates and of family businesses are expected to be subject to tax under an exemption of \$3.5 million or \$5 million. This share would grow slightly over the 10 year budget horizon, but indexing the exemption would not be very important over this short time period.*

*The estate tax is a small, but highly progressive, element of the tax system. Under the proposals under consideration (the \$3.5 million exemption and the \$5million exemption), the majority of the tax falls on estates of \$20 million or more, which in turn constitute only three-hundredths of 1% of decedents. For the \$3.5 million exemption, 45% rate effective in 2009 and under consideration as a permanent treatment, 96% of the tax falls on the top quintile of the income distribution, 72% falls in the top 1% and 42% in the top 0.1%.*

*Effects of savings are uncertain in direction but likely small. Based in empirical evidence, a decline of 1% to 2% in charitable contributions from increasing the estate tax relative to the current law baseline of a \$1 million exemption with a 55% rate would be expected. Costs of estate planning and administration are relatively small as a percent of estate tax revenue.*

*Because transfers between spouse are exempt, allowing spouses to inherit the exemption can increase the combined couples ' exemption, and simplify estate planning This change could cost increasing amounts of revenue over time, however, and lead to certain administrative complications.*

*Several provisions to deal with perceived abuses might be considered, with the most important one relating to the use of discounts when assets are left to a family partnership and no one heir controls the property.p.18.*

## **VII. WHAT IS TO COME?**

- A. Predicting what action Congress may take with respect to the federal estate tax has odds of accuracy slightly better than predicting the next number to win the Powerball lottery.
- B. Virtually all commentators since the passage of EGTRRA in 2001 predicted that Congress would take action to permanently amend or at least extend the federal estate tax in some form prior to December 31, 2009. All were wrong.
- C. Most if not all of the factors present in December 2009 which contributed to the failure of Congress to extend the federal estate tax prior to January 1, 2010 are still present.
- D. That 2010 is an election year with the potential change of control of the House of Representatives and a potential change in the composition of the Senate makes prediction of congressional action more speculative than is normal.
- E. There are a number of significant issues which are likely to be addressed by Congress in some fashion prior to the end of the calendar year, even if action is only for media, public relations, election campaign or partisan purposes. Some of these significant issues include:



- 1) National immigration policy and enforcement
- 2) Environmental concerns resulting from the oil spill in the Gulf of Mexico;
- 3) The increased financial regulation of banks, brokers and Wall Street;
- 4) The nomination of Elena Kagan to the US Supreme Court;
- 5) Troop removal from Iraq and Afghanistan;
- 6) “Clean up” legislation to the healthcare legislation;
- 7) Possible action to stimulate the economy;
- 8) Funding for education matters – “Race To The Top”
- 9) Action on the federal budget deficit and the federal debt;
- 10) Other sudden, unexpected issues such as issues involving the global economy and situations which may arise as a result of economic crisis in countries such as Greece, Spain, Portugal, Ireland or other nations, or perhaps a major terrorist incident.

It is evident there are many topics which could, might or must receive congressional attention. The federal estate tax might well be given low priority in comparison to the other matters.

- F. The relative “low profile” of estate planning uncertainty compared to other issues which receive national and international media attention may detract from the impetus to take action regarding the estate tax.
- G. A relative lack of contact with the “real world” of day to day planning and transactions on the part of the members of Congress and their staff advisors may generate a low sensitivity to the ramifications of a lack of certainty upon planning real world, day to day transactions.
- H. The public material and statements regarding the status and degree of consensus among the members of Congress regarding the estate tax are difficult to reconcile.

The Congressional Research Service Report cited above states: “There is general agreement that some sort of estate tax will be retained.”

However the June 1, 2010 RIA Newsletter in a short article entitled “Progress on Estate Tax Uncertain” cites Senate Finance Committee Chair Max Baucus (D-MT) as saying: “There is no agreement on estate tax in either substance or process—none whatsoever, ...”

- I. If the comments contained in the Report of the Congressional Research Service

represent the perspective of members of Congress, and perhaps more importantly the perspective of the staff members of the members of Congress, then the likelihood of a new estate tax law rather than allowing the existing statute remain in place would seem dim. The Report points out the small number of total estates affected by the estate tax, even with the \$1 million exemption; the negligible effect upon small businesses and farms; and the highly progressive nature of the tax. Each of these factors would seem to mitigate in favor of no change and allowing the 2001 estate tax to be reinstated.

- J. News reports concerning the death of Dan Duncan, a Texas gas pipeline billionaire on March 28, 2010 place the value of his estate in the \$9 billion range. Some commentators cited in the new articles say the consequences of the death of a person with such wealth make the likelihood of a retroactive estate less likely due to the greater likelihood of constitutional litigation.
- K. The most significant factor affecting the enactment/reenactment of a federal estate tax might be the projection of addition revenue generated by the estate tax, especially when such revenue is perceived as originating from taxpayers in the very top levels of income or wealth.
- L. What is to come? Your guess is as good as mine.

#### **VIII. REFERENCES**

Two excellent discussions of the ramifications of the lapse of the federal estate tax and the possible (probable?) can be found in:

*The Impact of Estate Tax Repeal—Going Blindly Where No One Else Has Gone Before*, a telephone seminar originally presented January 13, 2010 and repeated on several subsequent dates, Co sponsored by ALI-ABA and ACTEC.

*2010 And Beyond—The Transfer Tax Odyssey*, Nichole D. Fitzgerald and Christopher W. Boyett, Practical Tax Strategies, April 2010.

## APPENDIX

### AN ACT

ENTITLED, An Act to provide that certain tax laws applicable on December 31, 2009, apply to certain wills and trusts that refer to federal estate and generation-skipping transfer tax laws, and to declare an emergency.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF SOUTH DAKOTA:

Section 1. A will or trust of a decedent who dies after December 31, 2009, and before January 1, 2011, that contains a formula referring to the unified credit, estate tax exemption, applicable exemption amount, applicable credit amount, applicable exclusion amount, generation-skipping transfer tax exemption, GST exemption, marital deduction, maximum marital deduction, unlimited marital deduction, inclusion ratio, applicable fraction, or any section of the Internal Revenue Code relating to the federal estate tax or generation-skipping transfer tax, or that measures a share of an estate or trust based on the amount that can pass free of federal estate taxes or the amount that can pass free of federal generation-skipping transfer taxes, or that is otherwise based on a similar provision of federal estate tax or generation-skipping transfer tax law, shall be deemed to refer to the federal estate tax and generation-skipping transfer tax laws as they applied with respect to estates of decedents dying on December 31, 2009. This provision does not apply with respect to a will or trust that is executed or amended after December 31, 2009, or that manifests an intent that a contrary rule applies if the decedent dies on a date on which there is no then-applicable federal estate or generation-skipping transfer tax. If the federal estate or generation-skipping transfer tax becomes effective before that date, the reference to January 1, 2011, in this section refers instead to the first date on which such tax becomes legally effective.

Section 2. The personal representative or any affected beneficiary under the will or other instrument described in section 1 of this Act may bring a proceeding to determine whether the decedent intended that the formulae under section 1 of this Act be construed with respect to the law as it existed after December 31, 2009. Such a proceeding shall be commenced within twelve months following the death of the testator or grantor.

Section 3. The provisions of this Act apply to decedents dying after December 31, 2009, and before January 1, 2011.

Section 4. Whereas, this Act is necessary for the immediate preservation of the public peace, health, or safety, an emergency is hereby declared to exist, and this Act shall be in full force and effect from and after its passage and approval.

# The Use of Trusts to Incentivize the Beneficiary

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P. Daniel Donohue is a partner in the law firm of Davenport, Evans, Hurwitz & Smith, L.L.P., in Sioux Falls, South Dakota where he has practiced law since 1974. Mr. Donohue is 1971 graduate of the University of Notre Dame (BBA in Accounting with honors) and a 1974 graduate of the University of South Dakota School of Law. He is a former President of the Sioux Falls Estate Planning Council and the Minnehaha County Bar Association. His practice involves estate planning with an emphasis on trust administration. He is a Fellow of the American College of Trust and Estate Counsel, currently serving on the College's Board of Regents, and a Fellow of the American College of Real Estate Lawyers. He is also listed in *The Best Lawyers in America*, *Who's Who in American Lawyers*, and *Chambers USA*. Mr. Donohue is a contributor to *Asset Protection: Domestic and International Law and Tactics*, published by Clark Boardman Callaghan (1995) and has lectured on private trust companies, trust administration and trust situs issues at American Bar Association meetings, the University of Notre Dame Tax and Estate Planning Institute, the University of Miami Heckerling Institute on Estate Planning, the New York City Estate Planning Council, and Regional and National Meetings of the American College of Trust and Estate Counsel. He is currently serving as a member of the South Dakota Governor's Task Force on Trust Administration Review and Reform.

# PLANNING AND DRAFTING FOR THE USE OF INCENTIVE TRUSTS

## I. Introduction.

Public announcements by U.S. citizens in opposition to transfer tax repeal have drawn attention to some estate planning trends. Wealthy individuals no longer seem willing to focus solely on traditional strategies designed to transfer assets to or for the benefit of a spouse and then ultimately to descendants or other family members. Estate planning for clients with larger estates has traditionally centered on those strategies that have been designed to reduce transfer taxes. Estate planners and advisors have assumed that a client's primary goal would be to minimize the amount of transfer taxes in order to maximize the amounts available to family members and more remote descendants. It now appears that some clients have determined that transfers of valuable assets, whether outright or in trust, could ultimately be detrimental to succeeding generations. Public statements by members of the Buffet and Gates families underscore the fact that wealthy clients may desire to use their estate plans to both encourage appropriate behavior and, at the same time, discourage inappropriate behavior by beneficiaries. In addition, many clients have certain beneficiaries with specific needs that may be addressed through unconventional estate planning.

There seems to be a greater interest from our clients with regard to the use of incentive trusts. Clients also appear to be allocating a much larger share of their assets to non-profit entities and charitable trusts. Clients are also establishing private foundations or donor-advised funds with their local community foundations. These trends suggest that our clients are truly becoming more concerned about the effect that accumulated wealth will have on their descendants. Some primary concerns would appear to be in the areas of motivation, personal self-sufficiency, self-esteem, productivity, and addictive behavior. At the same time clients have a natural desire to provide resources to their descendants to assist them with financial support for education, health care, financial training, family support, and business ventures.

It is unlikely that the federal transfer tax system will be abolished. No one knows for certain whether Congress will tackle transfer tax legislation in 2010. However, an alternative may involve increases in

exemptions. In addition to the tremendous interest in dynasty trusts that can be extended beyond the typical perpetuities period, the increased exemption equivalent will give planners and their clients more latitude for generational incentive trust planning. It may be more important for estate planners to focus attention on drafting those types of incentive provisions that will influence the behavior of trust beneficiaries.

## II. Beneficiaries.

A. Children. The first obvious class of persons to be affected by incentive trusts would be the children of our clients. However, depending upon the wealth of the client and the client's age, there may be a greater focus on grandchildren and more remote descendants. For example, many clients seem quite concerned about the lifestyle that they would hope to maintain for themselves and their spouses. Although in recent years there are many clients who have accumulated significant wealth at much younger ages, most of our clients are not inclined to make special provisions for their descendants until they are certain that they have set aside sufficient assets to provide for their own care and support. In some circumstances our clients' children are successful in their own right and may not need significant financial assistance. There are also situations where children may not appreciate any attempts by their parents to mold the behavior of grandchildren and great-grandchildren. It should also be noted that the goals and objectives of our clients may change over a period of time as they observe the growth and development of their children and grandchildren. Since planners generally accept the idea that transfer taxes will not be repealed, they will probably continue to tout transfers for children and grandchildren as early in the lives of these beneficiaries as possible. Particularly for generation three and beyond, it is likely that estate planners will promote larger gifts at younger ages. It could be argued that the need for incentive trust provisions will increase regardless of federal transfer tax exemption.

B. Remote Descendants. It has always seemed a bit difficult to assist clients with planning for benefits directed at remote descendants. Clients are generally disinclined to make specific provisions for later generations because the clients seem to prefer arrangements that benefit their descendants who are actually known to them. As generation-skipping trusts and dynasty trusts are recommended more frequently, the average client seems to be more inclined to establish distribution requirements that are based on the client's particular value system and the values that the client may wish to promote among the client's more remote descendants.

The value systems of our clients are certainly as varied as their own life experiences.

C. Spouses. Many clients fully expect that their spouses will remarry following the client's death. While QTIP Marital Trusts are often used by clients to ensure that property is ultimately distributed to the client's descendants, the client clearly will not be able to encourage certain desirable behavior by a surviving spouse because of the QTIP requirements. However, with respect to non-marital trusts, the client may often desire to diminish or eliminate the distribution of income or principal to a surviving spouse in the event of the spouse's remarriage or cohabitation with a prospective suitor. Clients are equally concerned about the distribution of principal from a typical marital trust that provides the surviving spouse with a general testamentary power of appointment.

D. Other Beneficiaries. Our clients often have certain beneficiaries who have special needs that the client feels compelled to address in the client's estate plan. For example, there may be a class of individual beneficiaries who have markedly different income levels and significant disparities in overall wealth. For those beneficiaries who are less affluent, our clients will often try to limit the use of principal in order to provide resources to the beneficiary throughout the beneficiary's lifetime. This can apply to descendants as well as unrelated or charitable beneficiaries.

### III. Good Behavior.

A. Education. Education is most frequently the subject of incentive trusts. Encouraging education may often involve the recognition of specific educational achievements. For example, a beneficiary may be rewarded for the commencement and pursuit of a general bachelor's degree. Incentive trusts may specify a certain level of achievement, specific areas of study, and specific educational institutions. Other clients prefer to use a broad definition of the term "education." A sample of an expanded definition of this term is found on Schedule 1.

Our clients may also be inclined to promote the attainment of advanced or professional degrees and the achievement of certain grade point averages or the receipt of academic honors. Living expenses may also be provided to beneficiaries who seek a degree from an accredited college or university. Our clients may also desire to provide the Trustee with the latitude to reward beneficiaries based on all of the facts and circumstances, including the beneficiary's own abilities or disabilities.

Incentive trusts may also be used to permit or encourage an adult beneficiary to return to school to improve certain skills or develop professional expertise.

B. Productive Behavior. Many clients want to encourage productive behavior. Income matching provisions are sometimes used to promote industrious activity by a beneficiary. Care must be taken to clearly define the term “earned income.” The amounts of earned income shown on a W-2 form are easy to determine. However, self-employed beneficiaries or those who are members of a partnership may not receive a substantial salary. Earned income may be reduced during periods of unemployment due to disability. How will income matching provisions address adjustments made when a beneficiary’s tax return is audited? How should a beneficiary who chooses to provide care to children or dependent adults be treated? Although the landscape has clearly changed regarding opportunities for female beneficiaries, is it appropriate to provide a trustee with the discretion to treat male and female beneficiaries differently? Lastly, certain occupations may produce less earned income but could be just as worthwhile. If a beneficiary has extraordinary earned income in a given year that is due to unusual factors, would this produce a windfall for the beneficiary by reason of the matching distribution from an incentive trust? Would it be more appropriate to use an average of the beneficiary’s earned income over several years? These are all factors for the estate planner and the client to consider.

C. Public Service. It is possible that our clients may want to encourage beneficiaries to consider full-time activity in service-related positions. Various ministries that provide service and assistance to non-profit agencies might be favored. Missionary work, service in the Peace Corps, and government service might also be encouraged. Other careers as teachers, artists, or social workers might be encouraged. A client may authorize the distribution of trust income to supplement the income of beneficiaries who work in these areas. It might also be appropriate for the trustee to be permitted to provide these beneficiaries with certain items that they could not otherwise afford, including computer equipment, cars and travel.

D. Philanthropy. Other types of incentive trusts may encourage charitable giving by the trust beneficiaries. Clients with definite philanthropic tendencies generally want to encourage their descendants to philanthropic as well. The allocation of a certain percentage of trust income or principal for distribution to non-profit organizations, coupled with a requirement that a beneficiary or committee of beneficiaries designate



the recipients, can help get the beneficiaries involved in philanthropy. The client can also provide that the incentive trust will match personal charitable contributions made by each beneficiary within certain limits. It is important to carefully consider all pertinent income and transfer tax issues since it might be more appropriate for a client to establish a family foundation or a specific charitable trust. And lastly, a client may use charitable gifts from a trust that could reduce the distribution of principal to certain descendants who fail to meet or exceed well-defined criteria.

E. Special Family Needs. In some families there may be a need for individual family members to provide care for elderly family members or relatives, physically or mentally disabled family members, and non-relatives who may rely upon the client for certain types of care. Incentive trust provisions may be drafted to provide significant benefits to a beneficiary who fills these needs. It is extremely important to carefully craft trust provisions to fairly compensate a beneficiary who is not able to maintain full-time employment as a result of the caregiving services provided to family members and other non-relatives. It may also be appropriate to allow trust income or principal to continue to be distributed to the beneficiary for a specified period of time after the death of the disabled person or after that person is institutionalized.

#### IV. Bad Behavior.

A. Addictive/Criminal. Drug abuse, alcohol abuse, and criminal behavior may be discouraged through the use of an incentive trust. The distribution of income and principal may be discontinued or delayed. At the same time the incentive trust may provide benefits in order that the family member or descendant is able to obtain treatment and to ensure that basic living needs are funded. Some clients may require that a beneficiary make all medical records available to the trustee and submit to blood tests to allow the trustee to determine if the beneficiary is involved with substance abuse.

B. Spending. Some clients may desire to limit distributions to beneficiaries who fall in the category of consummate consumers. Trust provisions can require the beneficiary to provide the trustee with income tax returns and various financial information in order to be eligible for trust distributions. There are other incentive trust provisions which may give a trustee the flexibility to withhold distributions to beneficiaries who are not productively employed or engaged in productive activities. Incentive trusts will always include spendthrift provisions. Clients will rarely want to see

distributions to a trust beneficiary indirectly used to accommodate the beneficiary's creditors or a former spouse of the beneficiary.

C. Charity. While certain clients may desire to encourage the beneficiaries to be philanthropic, other clients may wish to discourage charitable activities. Clients may try to discourage unusual or extraordinary charitable giving while at the same time fostering the appropriate asset stewardship among younger generation beneficiaries. The client may establish certain limitations with regard to contributions by trust beneficiaries to non-profit organizations. If those limits are exceeded, the benefits from the incentive trust may be reduced by the trustee.

## V. Planning Techniques.

Trusts are probably the most familiar vehicle that estate planners use to influence the behavior of beneficiaries. Trusts are established to hold property that our clients do not want to transfer outright to a beneficiary.

A. Qualified Minors Trusts/Crummey Trusts. A qualified minor's (§ 2503(c)) Trust allows a client to provide specific instructions to the trustee regarding the use of principal and income. Although actual distributions can be left to the discretion of a trustee, it is important that no substantial restrictions be imposed upon the discretion of the trustee if the client desires to take advantage of annual gift tax exclusions. These trusts are not considered to be the best vehicles for incentive purposes as the beneficiary receives the trust assets when reaching age 21. Some practitioners try to circumvent this particular problem by providing the beneficiary with the right at age 21 to compel distribution of the trust principal but limiting that right to a specific period of time. Even though a § 2503(c) Trust of this nature may continue until the beneficiary attains a specified age, clients generally prefer not to use this type of a trust because of the beneficiary's right to withdraw trust principal at age 21. Some states allow a § 2503 Trust to be extended. Due to this particular uncertainty, clients generally prefer the use of discretionary trusts with Crummey provisions. The use of these trusts beginning when beneficiaries are very young will generally provide a client with some assurance that the power of withdrawal will not likely be exercised. Crummey trusts most certainly can include typical or not so typical incentive provisions and may continue until the expiration of the applicable perpetuities period.

B. Trusts for UTMA Accounts. Some clients who have established UTMA accounts for children and grandchildren become quite concerned as the child or grandchild turns 18. Clients have three choices. First, the “head in the sand” approach requires a client to avoid mentioning anything to the child or grandchild about the UTMA account. The head only pops out of the sand if and when the bank or brokerage company makes inquiry regarding authorization for investment of UTMA account assets. Second, the grantor can quietly advise the beneficiary (or the beneficiary’s parent(s)) that the minor will own the UTMA account at age 18, but still make arrangements for the continued management of the account assets through a power of attorney. The child or grandchild usually senses the need to permit the parent or grandparent to continue to manage the account. A grab and run tactic implemented by the child or grandchild would only serve to dissuade the parent or grandparent from making future gifts and bequests. The third option involves the encouragement of the minor to establish a grantor trust for the UTMA account assets. This trust could continue until any specified age and the child or grandchild could serve as a co-trustee of the Trust. The other co-trustee would typically be given the discretion with regard to distributions of principal and income in connection with the trust’s incentive provisions. This type of trust may be used to extend a § 2503(c) trust as well. As counsel for our clients, it is important that the trust beneficiary understand that the lawyer represents the parent or grandparent and not the beneficiary.

C. Pot/Individual Trusts. Pot trusts and trusts established for individual beneficiaries are commonly used to support behavior that our clients want to emphasize. In particular, these trusts may contain specific incentive provisions but commonly will provide for distributions of income and principal at the discretion of the trustee. They are also commonly used for education, health, maintenance and support. Unequal distributions are commonly permitted.

D. Dynasty Trusts. Dynasty or generation-skipping trusts will generally include distributive provisions that grant the trustee great latitude with regard to the distribution of both income and principal. Clients who are interested in certain incentive trust provisions may also have some firm ideas regarding limitations on the types of investment the trustee can make. It is very important to carefully select any objective qualifications so that beneficiaries may be able to meet the criteria and qualify for distributions. It is equally important for the client to clearly express a client’s intentions in order to provide clear direction to the trustee. During the consultation and drafting process, the client should be encouraged to

review several possible situations to make sure that 1) the trustee will have the appropriate information in order to properly administer the incentive/disincentive provisions; 2) the burdens on the trustee and the beneficiary to administer the provision do not exceed the prospective benefits; 3) the tests or qualifications are very clear so that disputes between the trustee and beneficiary can be avoided; 4) any disputes that arise can be resolved without resorting to litigation; and 5) the beneficiaries will not be able to manipulate the incentive/disincentive provisions in order to achieve results that are contrary to the purposes of the trust. Clients must be encouraged to thoughtfully consider the objectives of the trust and restrictive provisions that might be necessary or appropriate.

Trustee Indemnification. In order for discretionary trusts to work properly, it is imperative that the client provide the trustee with every appropriate protection so the trustee can exercise discretion as intended by the client. State laws may not provide adequate protection in connection with the exercise of discretion by trustees. For example, South Dakota law, specifically SDCL 55-1-43, provides that a discretionary interest is neither a property interest nor an enforceable right. And a court may review a trustee's distribution discretion only if the trustee acts dishonestly, acts with an improper motive, or fails, if under a duty to do so, to act. Even if applicable state law is well-defined, the trust instrument must clearly express the client's desire that the exercise of discretion by the trustee will not be subject to challenge by any beneficiary. Appropriate exculpatory language should be included and the trust corpus should be available for indemnification of the trustee for any actions made or taken in good faith. The estate planner should also visit with the client about the use of an *in terrorem* provision even though this type of a provision could be unenforceable under applicable state law. An alternative trust provision would be to require that all trust expenses incurred in defending any litigation be charged to the share of the beneficiary who initiates the claim or brings the litigation.

Pure Incentive Trusts. Most incentive trusts are established so that beneficiaries will receive distributions if and only if they are able to achieve certain specific criteria that contain very objective standards. If the objective is abstinence from the use of drugs or alcohol, gainful employment, fiscal responsibility or academic achievement, it is important to provide a very objective standard that is clearly understood and easily administrable by the trustee. Properly drafted incentive trusts will discourage beneficiaries from activities that would be intended to provoke distributions by a trustee based to a greater extent on sympathy or the threat of undesirable behavior. A beneficiary should find it difficult to use

trust provisions to extract discretionary distributions from the trustee. Unlike a fully discretionary trust, an incentive trust requires the beneficiary to meet or adhere to clear guidelines established by the client.

Other Considerations.

A. COLA. In those cases where dynasty or generation-skipping trusts contain incentive provisions, the client should include a requirement that any fixed amount be regularly adjusted for changes in the cost of living.

B. Beneficiary information. Beneficiaries must be encouraged to comply with reasonable requests from the trustee for information that is relevant to any determinations that the trustee is required to make. This may include access to medical records, employment records, financial records and tax returns, school records, and other confidential information.

C. Family Advisor. The estate planner should consider the use of a family advisor or an advisory committee that would be responsible for providing the trustee with pertinent information about each trust beneficiary.

D. Division of Trust. Since incentive trusts will usually involve unequal distributions among the trust beneficiaries, the typical “pot” or “basket” trust may produce significant discord among family members. The client should be encouraged to consider requiring the division of the trust assets along family lines or in some other objective fashion.

E. ADR. The client should also consider the use of mediation or binding arbitration in order to resolve disputes without litigation as long as the mediator will not be allowed to usurp the duties of the trustee.

F. Trust Protector/Special Trustee. For those generation-skipping or dynasty trusts, it would be appropriate for the client to establish an independent, unrelated trust protector with the power to amend the trust instrument for specific tax purposes or to change the situs of the trust. Typical state laws that provide for the appointment of a trust protector allow the client to establish the trust protector’s powers and discretions and further direct that the exercise or failure to exercise of any specific powers shall be binding on all persons interested in the trust. For example, South Dakota law allows the use of trust distribution advisors.

G. Situs. The client and the estate planner should carefully determine the appropriate situs for the trust. If a trust protector is not utilized, the trustee should be given the power and authority to change the situs of the trust. The client may want to permit the trust to be administered in an offshore jurisdiction. It is important for the trustee to have the power to select the most appropriate situs for the trust in light of the client's objectives.

H. Income Taxes. The trustee may be directed to consider the income tax effects of distributions, and gross-up a beneficiary's distribution to account for income taxes payable by the beneficiary.

#### VI. Other Vehicles.

When focusing on incentive estate planning techniques and provisions, the estate planner should not overlook the importance of the use of family business entities. Family business organizations may be used quite effectively as tools for encouraging appropriate behavior by family members. With typical family limited partnerships, limited liability companies, or closely-held corporations, the rights of the limited partners, minority shareholders and members are usually restricted. The timing of distributions to children and grandchildren or trusts established for their benefit can be controlled to a certain degree. Charitable trusts and private foundations can also be vehicles for involving family members with investment decisions and philanthropy.

#### VII. Conclusion

Estate planners should continue to focus their efforts more carefully on counseling their clients with regard to the use of both discretionary and pure incentive trusts. If there is less of a need to emphasize transfer tax planning, it may be more important to focus on serving more as a family counselor to help our clients address their family relationships and to develop appropriate goals and objectives. In many situations incentive trust provisions coupled with some trustee discretion may better serve the client's needs. Incentive trusts are very well suited for those situations where a client may want to disinherit a child but not entirely. However, incentive trust provisions need to be carefully drafted and thoroughly reviewed by the client. Exculpatory provisions to protect trustees who act in good faith are absolutely necessary. Schedule 1 contains several sample incentive trust provisions.

## SCHEDULE 1

### SAMPLE PROVISIONS

1. Definition of Education. The term "education" shall mean education, training or institutional care at any private school, night school, public school, preparatory school, military academy, junior college, college, university, graduate and professional school, trade school, school for retarded, blind or handicapped (whether physically, perceptually, emotionally or mentally) children or adults or school for children or adults subject to learning disabilities or hostels, half-way houses, sheltered workshops associated with private living arrangements and the like, whether connected with a private institution or not, as well as any other similar institutions not mentioned herein, either in the United States or abroad.

Expenses incurred for education shall be deemed to include tuition, board, lodging, school uniforms, any special clothing needed for school, books, supplies, tools, instruments, laboratory, health, gymnasium and other fees and incidental expenses, medical and psychiatric care, as well as transportation expenses for trips between home and said institution, and all other services and things (including vocational apprenticeships, internships and residences) connected with any course of study, provided that in each such case, the course of study is approved by the Trustee.

In addition, the term "education" shall include expenses incurred for travel which the Trustee believes will contribute to the educational experience of the person undertaking the travel. However, the term "education" does not include any and all travel and the Trustee shall be judicious in approving or reimbursing expenses for educational travel.

2. Distribution Upon Entering College. At any time after a beneficiary has commenced a course of study at an accredited college or university with the objective of obtaining a bachelor's degree in a subject which the trustees, in their discretion, deem reasonably likely to prepare the beneficiary for financial self-sufficiency, the trustees may make a single-lump-sum distribution to the beneficiary from his or her trust of an amount not to exceed \$\_\_\_\_\_. The Trustees may also make this one time distribution to a beneficiary who does not satisfy the foregoing requirements, but who has commenced a course of study or training which the trustees, in their discretion, determine to be reasonably equivalent to the pursuit of a bachelor's degree in light of all of the facts and circumstances, including the beneficiary's abilities or disabilities and the beneficiary's career goals. The distribution described in this paragraph may be made to the beneficiary no more than once during his or her lifetime.

3. Distribution Upon Receiving a Bachelor's Degree. At any time after a beneficiary has received a bachelor's degree from an accredited college or university, or such other degree or certification as the trustees, in their discretion,

shall deem reasonably equivalent to the attainment of a bachelor's degree in light of all of the facts and circumstances, including such beneficiary's abilities or disabilities, or the beneficiary's career goals, the trustees may make a single, lump-sum distribution to the beneficiary from his or her trust of an amount not to exceed \$\_\_\_\_\_. In determining the amount to be distributed under this paragraph, the trustees may take into account, for example, the degree of difficulty of the beneficiary's curriculum, the beneficiary's grade point average and any academic honors received by the beneficiary. The distribution described in this paragraph may be made to the beneficiary no more than once during his or her lifetime.

4. Distribution Upon Receiving an Advanced Degree. At anytime after a beneficiary has received an advanced degree (such as a master's degree, a PhD, an MBA or a professional degree) from an accredited college or university, or such other educational achievement as the trustees, in their discretion, shall deem reasonably equivalent thereto in light of all of the facts and circumstances, including such beneficiary's abilities and disabilities, the trustee may make a single, lump-sum distribution to the beneficiary from his or her trust of an amount not to exceed \$\_\_\_\_\_. The distribution described in this paragraph may be made to the beneficiary no more than once during his or her lifetime.

5. Indexing for Inflation. On each anniversary date of this trust agreement ("the Adjustment Dates"), every specific dollar amount established with regard to distributions that the trustee is directed or permitted to make by this trust agreement shall be adjusted by the percentage increase or decrease in the Consumer Price Index (as hereinafter defined) which occurs over the one-year period ending on the last day of the month preceding the Adjustment Date. The adjustments shall be effective as of the Adjustment Date and shall remain effective until the next adjustment provided for herein. As used herein, "the Consumer Price Index" shall mean the national Consumer Price Index--All Urban Consumers as published by the United States Bureau of Labor Statistics (or any other federal government agency or office which assumes the functions of the United States Bureau of Labor Statistics or performs the current functions of such office in calculating and publishing price indices). If the United States Bureau of Labor Statistics or its successor office ceases to publish the national Consumer Price Index--All Urban Consumers then the parties shall use the Price Index published by the United States Bureau of Labor Statistics or its successor office which is most comparable to the Consumer Price Index--All Urban Consumers. The trustee may select any comparable index in the event the United States Government no longer publishes an index to measure inflation/deflation.

6. Distributions to Match the Beneficiary's Earned Income. The trustees may distribute to a beneficiary on a monthly, quarterly, annual, or other basis, as much of the net income, and, to the extent the net income is insufficient, the principal, of the trust for each dollar of income earned by such beneficiary. The trustees' determination of the amount of income and principal distributable to the beneficiary under this paragraph, if any, shall be absolute and binding upon all



persons interested in the trust estate. The trustees may, for example, equate the income earned by the beneficiary to his or her adjusted gross income for federal income tax purposes, reduced by investment or passive income (such as rents, dividends, and interest), income from relief of indebtedness, capital gains, and government benefits, if any, and such other adjustments as the trustee deems appropriate under the circumstances. The trustees may make interim distributions to a beneficiary prior to their final determination of such beneficiary's earned income based upon such documentation of earnings as the trustees deem appropriate, including, without limitation, the beneficiary's W-2 forms, pay stubs, business profit or loss statements, or draft tax returns. No reimbursement shall be required of any beneficiary who has received a distribution under this paragraph based upon an estimate of his or her adjusted gross income if such adjusted gross income for the year in question is subsequently determined to be less than that estimated, or if such adjusted gross income is reduced as a result of an audit of, or amendment to, the beneficiary's federal income tax return, provided, however, that the trustees may, in their discretion, reduce distributions in subsequent years to such beneficiary pursuant to this paragraph to reflect such prior overpayment. The distribution authorized under this paragraph shall be made to the beneficiary as soon as practicable after the amount of such distribution, if any, has been determined by the trustees. In no event shall the distributions to a beneficiary under this paragraph exceed \$\_\_\_\_\_, collectively, in any calendar year.

7. Withholding Distributions to a Beneficiary Not Engaged in Productive Activities. Notwithstanding any provision of this trust agreement to the contrary, the trustees may withhold any distributions of income or principal to, or for the benefit of, any beneficiary which are authorized or required under the terms of this trust agreement, if the trustees determine such beneficiary is not engaged in productive activities. In reaching such a determination, the trustees may consider, for example:

- (a) whether the beneficiary is seriously pursuing an education which will enable the beneficiary to obtain gainful employment commensurate with his or her goals and abilities;
- (b) whether the beneficiary is working to support himself or herself in a manner commensurate with his or her abilities (even if such beneficiary's chosen career does not produce substantial income but makes a productive contribution to the community);
- (c) whether the beneficiary is working in the home as a parent in the care of such beneficiary's children or other family members;
- (d) whether the beneficiary is free of substance abuse or other negative addictive behavior;

(e) whether the beneficiary is capable of managing money in a responsible manner as demonstrated by past conduct;

(f) whether distribution to the beneficiary would serve to benefit such beneficiary's creditors, including former spouses, rather than the beneficiary; and

(g) if the circumstances warrant, whether the beneficiary is involved in activities which promote the welfare of others or of the beneficiary's community as a whole.

7. Distributions to Substance Abusers. In making distributions to or for the benefit of any beneficiary whom the trustee believes may have substance abuse problems, we request that the trustees limit distributions to such beneficiary to those which the trustees deem necessary to ensure that such beneficiary's basic living requirements are met. In making distributions for the basic health and maintenance needs of a beneficiary with substance abuse problems, the trustees are requested, to the extent practicable, to make payments directly to persons or organizations who are furnishing housing, utilities, health care (including health care insurance), and other basic goods and services to the beneficiary, rather than directly to the beneficiary.

8. Distributions to Assist in Starting a Business. At any time after a beneficiary has attained at least \_\_\_\_\_ (\_\_\_) years of age, upon the request of the beneficiary, the trustees may contribute to the beneficiary's maintenance and support, but are not required to do so, by assisting the beneficiary to commence a business or profession in which the beneficiary will be employed on a full-time or substantially full-time basis, alone or with others. Such assistance may be in the form of a loan (with or without interest or security), an outright distribution, an investment by the trustees in the proposed endeavor, or any combination thereof. Prior to making a distribution to or for the benefit of the beneficiary, the trustees, or persons selected by the trustees, shall meet or otherwise confer with the beneficiary to establish a realistic business plan in order to determine the likelihood that the beneficiary will become financially self-supporting through the proposed endeavor, the timing and amounts of distributions from the beneficiary's trust that would be required to ensure the success of the proposed endeavor, and whether such amounts would be reasonable in light of the risk of failure of the proposed endeavor, the remaining assets of the trust, and any other factors which the trustees deems reasonable under the circumstances. The trustees are discouraged from making a distribution under this Section to or for the benefit of any beneficiary who fails to cooperate with the trustees in establishing a realistic business plan for the proposed endeavor.

9. Distributions to Assist in the Purchase of a Residence. At any time after a beneficiary has attained at least 25 years of age, upon the request of the beneficiary, the trustees may contribute to the beneficiary's maintenance and support, but are not required to do so, by making a reasonable down payment for the purchase of an appropriate primary residence for the beneficiary, provided such payment shall in no event exceed \$\_\_\_\_\_, or \_\_\_\_% of the value of the residence, whichever is less. Prior to making any such distribution to or for the benefit of the beneficiary, the trustees, or persons selected by the trustees, shall meet or otherwise confer with the beneficiary to determine what constitutes an appropriate residence for purposes of this Section based upon the needs of the beneficiary and his or her family (if any), as well as the beneficiary's ability to pay expenses related to such residence (including debt service, property taxes, utilities and maintenance) from resources outside of the trust. The trustees are discouraged from making a distribution authorized under this Section to any beneficiary who fails to cooperate with the trustees in performing this analysis.

10. Spouse. References in this trust agreement to a persons spouse shall mean an individual who has been that person's lawfully married spouse (determined under the applicable laws of the jurisdiction in which that person resides or resided at the time of his or her death) for a period of at least two (2) years, or who was such person's lawfully married spouse for at least two (2) years at the time of such person's death (whether or not such surviving spouse subsequently remarries), except that an individual shall not be considered a person's spouse unless that individual is or was residing with the person as husband or wife at the time that it is necessary to determine the individual's status as a spouse. For purposes of determining whether an individual is or was residing with a person as husband and wife, the trustees shall disregard temporary and short term absences unrelated to an intentional marital separation (including, but not limited to) absences due to vacation or business travel, illness, education, or emergency), or long term absences unrelated to an intentional marital separation (including, but not limited to, absences where either spouse resides in a nursing home or other skilled care facility). The determination of whether an individual satisfies the requirements to be a person's spouse under this section shall be made in the trustee's sole and absolute discretion.

11. Change of Trust Situs. This trust agreement has been established in \_\_\_\_\_. Notwithstanding the foregoing, the trust protector (trustee/special trustee) shall have the power to direct, by written instrument (delivered to the trustees), the transfer of the situs of the trust to such other state of the United States or to such jurisdiction outside of the United States as the trust protector (trustee/special trustee) shall determine to be in the best interests of the trust estate and the beneficiaries of the trust, including the right to transfer the trust assets and to remove the trustee in the old situs, and to have a trustee appointed at the new situs. Following the change of situs, the administration of the trust shall be governed by the laws of the state (or country) of the new situs, but the interpretation and construction of the trust with respect to the distributive rights of the beneficiaries shall continue to be governed by the laws of the State of \_\_\_\_\_.

12. Divisions. The trustees shall have the discretion to create a separate trust for each beneficiary, and to divide the trust along family lines to be administered as separate trusts. The trustees shall also have the discretion to create a separate trust as to any share or portion of a trust disclaimed by a beneficiary, and to sever the disclaimed portion to be administered as a separate trust. In addition, the trustees shall have the discretion to divide a trust so as to qualify one of the separate trusts as a qualified S corporation shareholder or as any other type of special trust provided for under the Code. Further, the trustees shall have the discretion to divide any trust or trust share into two or more separate trusts for tax planning purposes or because of changed circumstances, litigation among beneficiaries, administrative difficulties, or other reasons suggesting a need for a division. The allocation of property between or among separate trusts created from a single trust or trust share may be unequal in amount and in the type of assets, and the division may be made non-pro rata.

13. General Trust Purposes. The primary purposes of the Trust shall be to provide the Grantors' great-grandchildren the opportunity to obtain a post-high school education. The secondary purposes of the Trust are to provide for medical and health needs of Grantors' great-grandchildren and to provide for their support needs should they decide to undertake missionary activities. Additional secondary purposes of the Trust are to provide Grantors' great-grandchildren with a down payment for a home and funds to pay for wedding expenses. It is also the Grantors' intention that the Trust assets shall not be relied upon by any Beneficiary as a substitute for productive effort by such Beneficiary to support himself or herself. Lastly, Grantors intend to reward their great-grandchildren who exhibit good moral character and specifically those great-grandchildren who do not have record of a conviction for any alcohol or drug offenses. Grantors intend to shelter the Trust property from generation-skipping transfer taxes. If there appears to be any ambiguity or conflict in the provisions of this Trust, such provisions shall be construed and applied to give effect to these intentions.

14. Multiple Beneficiaries. In making discretionary distributions to any Beneficiary where there is more than one permissible Beneficiary, the distributions need not be equal among the Beneficiaries (and may be made to one Beneficiary to the exclusion of the others) and shall not be charged against the ultimate distributive share of any Beneficiary on termination of the Trust.

15. Other Resources. In making discretionary distributions to any Beneficiary, the Trustee may take into consideration, to the extent the Trustee, in the exercise of its sole and absolute discretion, deems advisable, any other income or resources known to the Trustee to be available to that Beneficiary.

16. Distribution Events. No trust distribution shall be made until one of the following events occurs: 1) a Beneficiary enrolls in a vocational, college, university, graduate or professional school; 2) a Beneficiary has an uninsured medical need; 3) a Beneficiary personally engages in missionary work; 4) a Beneficiary purchases a residence primarily suited to the needs of the Beneficiary and the Beneficiary's immediate family, if any; and 5) a Beneficiary is married. In making discretionary distributions hereunder, the Trustee shall consult at least annually with the Grantors' then oldest living descendant who is not under a legal disability. Any such consultations shall not subject a descendant of Grantors to any fiduciary duties or obligations hereunder. Any recommendations or suggestions received by Trustee in connection with such consultations shall not be binding on the Trustee under any circumstances. In addition, in making discretionary distributions hereunder, the Trustee shall consider the amount of any federal, state or local income taxes payable by the Beneficiary as a result of a distribution to the Beneficiary. Furthermore, the Trustee shall make reasonable inquiry into any such great-grandchild's assets and sources of income or support and may require as a condition of any distribution that the great-grandchild provide the Trustee with such evidence relating to other assets and sources of income and support as the Trustee deems appropriate. Such evidence may include financial statements, tax returns and statements of past and projected income and expenses.

17. Distributions for Education Expenses. The Trustee shall pay to or apply for the benefit of one or more of the Beneficiaries so much of the net income and, to the extent the net income is insufficient, principal of the Trust as the Trustee determines, in its sole and absolute discretion, is appropriate to provide each Beneficiary an opportunity to obtain a post-secondary education. The term "education" shall mean education or training beyond the secondary school level at any junior college, college, university, graduate school, professional school, trade school, technical school, or school for retarded, blind, handicapped, or disabled person as each Beneficiary may choose. Distributions may be made only for tuition, board, lodging, books, supplies, tools, instruments, laboratory, health, gymnasium and other fees and incidental expenses, necessary travel and internship programs. Distributions shall not be made for expenses related to social activities, sports, motor vehicles, or entertainment. Annual distributions to a Beneficiary for education expenses shall be limited to a sum equal to 1) the net income of the Trust for the preceding calendar year divided by the number of Beneficiaries who receive a distribution for education expenses in the next calendar year, plus 2) the value of the Trust principal as of January 1<sup>st</sup> of the year preceding the distribution divided by the number of great-grandchildren of Grantors alive on January 1<sup>st</sup> of the year in which the distribution will be made, multiplied by a factor of .15. Distributions for educational expenses shall be restricted to those Beneficiaries who maintain a cumulative grade point average of 2.5 (on a 4.0 point scale) or an equivalent grade point average. The Trustee's discretionary authority to make distributions may be exercised unequally among the Beneficiaries according to the relevant circumstances affecting each Beneficiary, including the Beneficiary's academic talents and educational requirements. An illustration of the operation of the formula set forth above is set forth on Schedule B attached hereto.

18. Distribution for Medical Needs. The Trustee shall pay to or apply for the benefit of any great-grandchild of the Grantors so much of the net income and, to the extent the net income is insufficient, principal of the Trust as the Trustee, in its sole discretion, determines is necessary in the event of an uninsured medical need of such great-grandchild (other than drug or alcohol rehabilitation costs) provided that such person's income and other assets have been exhausted or are otherwise unavailable for such purpose. Distributions need not be made equally among the Beneficiaries and under no circumstances may distributions be made to or for the benefit of a spouse of any such great-grandchild. Annual aggregate distributions to great-grandchildren under this section shall be limited to \_\_\_\_\_ percent (\_\_\_%) of the value of the Trust principal on the first day of each calendar year.

19. Distribution for Support. In the event that a Beneficiary shall engage in missionary work, the Trustee shall pay to or apply for the benefit of such Beneficiary so much of the net income and, to the extent that the net income is sufficient, principal of the Trust as the Trustee, in its sole discretion, determines is necessary for the support and maintenance of such Beneficiary, provided that such Beneficiary's income and other means of support, such as parental support, have been exhausted or are otherwise unavailable for such purpose. Distributions under this section need not be made equally among the Beneficiaries. The Trustee shall also consider the Grantors' intention that distributions under this section should not be relied upon by any Beneficiary as a substitute for productive effort by such Beneficiary to support himself or herself. Annual distributions to any Beneficiary under this section shall be limited to an amount equal to \_\_\_\_\_ percent (\_\_\_%) of the value of the Trust's assets as of the first day of the calendar year in which the distribution occurs. Distributions to a Beneficiary pursuant to this section shall be limited to a period of three (3) years in duration.

20. Other Distributions. To the extent that the Trustee determines, in its sole and absolute discretion, that the current and future education, medical, and support needs of the Beneficiaries will not be significantly impaired, the Trustee may make distributions to any Beneficiary for the following purposes: 1) to reimburse a Beneficiary for all or any portion of the Beneficiary's wedding expenses; 2) to provide a Beneficiary with all or any portion of a down payment to permit the Beneficiary to purchase a home; and 3) to permit a Beneficiary to purchase or invest in a business in which the Beneficiary will be engaged on a full-time basis. Distributions need not be made equally among the Beneficiaries. Annual distributions to any Beneficiary under this section shall be limited to an amount equal to \_\_\_\_\_ percent (\_\_\_%) of the value of the assets of the Trust on the first day of the year in which the distribution occurs.

21. Separate Property. It is the Grantor's intention and direction that all distributions of both income and principal to any Beneficiary be deemed gifts to the Beneficiary alone and constitute the sole and separate property of the Beneficiary

receiving the distribution. Further, it is the Grantor's intention and direction that the Trust Estate shall never be subject to equitable distribution or other claim of a spouse or former spouse of a Beneficiary as a creditor of the Beneficiary or an order for child support by any court under the laws of any state or country.

22. Spousal Rights. It is Grantors' intention and direction that no spouse of any Beneficiary shall ever have any rights under this Agreement. It is the Grantors' intention and direction that no spouse of a Beneficiary shall ever have the right or power to compel any accounting of any Trustee acting hereunder nor shall any such spouse, or any court acting on behalf of the spouse, ever have access to the books or records of the Trust or the Trustee acting hereunder.

23. Court Interference - In addition, it is the Grantors' intention and direction that no court or other judicial authority shall have the power to compel any trustee to make any distribution which would directly or indirectly benefit a creditor including, but not limited to, a spouse or former spouse of any Beneficiary who is a creditor of the Beneficiary.

24. No Contest/Waiver. It is the Grantors' intention and direction that the Beneficiaries shall accept the actions of the Trustee hereunder without objection. In the event that any Beneficiary shall, directly or indirectly, object to any decision by the Trustee with regard to the retention or distribution of the income or principal of this Trust or in the event that any Beneficiary should, directly or indirectly assert any claim against the Trustee, file or promote the filing of a petition or application in any court to enjoin or compel the Trustee with regard to any distribution, or otherwise interfere with the administration of this Trust, such Beneficiary shall thereafter be ineligible for any distribution of income or principal from this Trust.

25. Evidence of Need. In exercising its discretion hereunder, the Trustee shall be entitled to rely upon the written certification of the Beneficiary or the guardian or other legal representative of the Beneficiary as to the nature and extent of the Beneficiary's Needs and the Beneficiary's resources apart from the Trust to meet those Needs. Such Trustee may, but shall not be required to, make further inquiry into the authenticity of the facts so certified.

26. Facility of Payment. The Trustee, in the exercise of its sole and absolute discretion, may make any distribution required or permitted to be made to any Beneficiary, in any of the following ways: (a) to the Beneficiary directly; (b) to the guardian or other legal representative of the Beneficiary; (c) by applying the funds directly for the Beneficiary without the interposition of any guardian or other legal representative; (d) to a custodian under any Uniform Gifts to Minors Act, Uniform

Transfer to Minors Act or similar Act pursuant to which a custodian is acting or may be appointed; (e) by reimbursing or making direct payment to the person who is actually caring for the Beneficiary (even though such person is not the legal guardian or other legal representative of the Beneficiary) for expenditures made for the Beneficiary; (f) to any other trust of which the Beneficiary is determined by the Trustee, in the exercise of its sole and absolute discretion, to have a significant beneficial interest, to be added to and administered as a part of such trust; or (g) in any other manner permitted by law. In exercising the discretion granted to the Trustee, the Trustee's decision with regard to the manner of distribution shall be final and conclusive with respect to all distributions made by the Trustee. Distributions in the manner provided in this section shall constitute a complete discharge of the Trustee with respect to that distribution; provided, however, that any distributions to a Beneficiary shall be made in a manner which fully complies with requirements and limitations concerning that distribution.

27. Termination for Unforeseen Events. The Grantors recognize some or all of the following conditions may arise in the future although they cannot now be foreseen:

- 1) A radical change in the political, economic or social order in the United States of America;
- 2) Legislation or court decisions highly detrimental to any trust created hereunder or to any Beneficiary, as such, hereunder;
- 3) Lack of availability of suitable trust investments for an extended period; and/or
- 4) Other events tending to greatly impair the intent and purposes of this instrument, including, but not limited to, a change in the tax laws that would result in the assets in any trust hereunder being taxed at a higher rate if held in trust than if distributed outright to such Beneficiary or Beneficiaries of such Trust.

Grantors further recognize, should these conditions or any of them occur, a termination of this Trust might be desirable. Therefore, if at any time the Trustee shall in its sole discretion determination that the continuation of any Trust created hereunder is contrary to the interests of the Beneficiaries for any of the above reasons, then the Trustee may make application to the then court of general jurisdiction in the place where such Trust shall have its situs. If such court, by appropriate decree, shall determine a condition coming within any of the foregoing standards has occurred, and the best interests of such Trust and of the person interested in it require the termination of such Trust, then the Trustee shall, following entry of such decree and obedient to its terms, distribute the property of such Trust to the then Beneficiary or Beneficiaries according to their respective interest, as set forth in such decree. No Trustee shall be required to consider any action under this section until a person interested in a Trust hereunder has requested such consideration in writing.



28. Special Trustee. The Trustee is authorized to appoint a special Trustee qualified to exercise fiduciary powers for the administration of property over which the Trustee shall make the determination, in the Trustee's discretion, it is not eligible to act or cannot administer in a practicable manner. The appointment of any such special Trustee shall be evidenced by an instrument in writing signed by the Trustee. So long as such appointment is in effect, any power or authority hereunder which would be exercisable by the Trustees may be exercised by the special Trustee with respect to the property designated for their administration with the same force and effect as if the Trustee had taken such action. The Trustee shall have the power to remove and replace a special Trustee by a written instrument.

29. Exercise of Discretion. Whenever the Trustee may have authority under any provision of this Trust Agreement to make any determinations which might affect the relative rights of any current income Beneficiary and any subsequent Beneficiaries, the Trustee shall have full power to make any determinations in favor of such current income Beneficiary without being answerable to any person for any such determinations; but no current income Beneficiary may compel the Trustee to make any determinations in his or her favor.

30. Investments. It is the intention of the Grantors that the investments of the trust assets consist of the highest quality securities. Grantors direct the Trustees to invest the trust assets in securities, including common and preferred stocks, corporate bonds, and money market funds, within the parameters and guidelines set forth in this Section 8.4. Investments in common and preferred stocks shall be limited to companies with market capitalizations commonly described as large capitalization companies. The market capitalization of these types of companies are currently at ten billion dollars or greater. No less than twenty percent (20%) and no more than thirty-five percent (35%) of the investments of the Trust shall consist of common or preferred stocks of large cap companies. No less than fifty percent (50%) and no more than sixty-five percent (65%) of the investments of the trust shall consist of corporate or tax exempt bonds. All bonds shall maintain a rating by Moody's, or an equivalent rating service, no less than A and shall have maturities that are of medium term on the date of purchase. Grantors also recommend that any tax exempt bonds be insured or pre-funded.

31. Change of Situs. The Trustee may transfer the situs of any trust created hereunder to another jurisdiction and may direct that the administration of the Trust shall thereafter be governed by the laws of such other jurisdiction. The power conferred on the Trustee under this section shall be a continuing power which may be exercised any number of times for the purpose of transferring the situs of the Trust.

32. Discretionary Distributions.

(A) Statement of Settlers' General Goals and Objectives. Settlers' overall objective in establishing and funding this Trust Agreement is that Settlers' Children and their issue become ethical, mature, responsible, self-sufficient, and productive adults. Settlers believe that a goal-oriented, responsible, and productive life provides happiness, satisfaction, and self-fulfillment; as a result, Settlers do not intend that trust distributions deprive or distract from the need of the Beneficiaries to have high standards for themselves, to work hard at their career and family responsibilities, and to experience the satisfaction of their own accomplishments.

(B) Statement of Settlers' Specific Goals and Objectives. In carrying out Settlers' overall objectives as set forth in Section (A) of this Article, the Trustee shall be guided by the following:

(1) Health Care. The Trustee may make distributions for health care costs, including fees of physicians, dentists, and other health care providers; surgery, drugs, and medication; hospitalization, outpatient and nursing care, including care at home; dental, including orthodontic, treatment, and surgery; psychiatric, psychological treatment, or counseling (including marital counseling); treatment for alcohol or drug addition, temporary or permanent stays in a rest or convalescent hospital, rest home, treatment or rehabilitation facility, or in a nursing home or community-based residential facility; travel or extended living away from home for reasons of health, and living expenses in connection with such travel or stays; and health or dental insurance premiums, or other costs of individual or group health plans. The Trustee shall consider the other income and resources of the Beneficiary (as provided in Article \_\_\_\_\_), and shall have the sole discretion in determining the appropriate distributions for medical and dental costs, and the Trustee's judgment in this regard shall be final and binding on a Beneficiary.

(2) Education. Settlers believe that the education of Settlers' Children and their issue is one of the most effective and important means to achieve the goals and objectives set forth in Section (A) of this Article. Accordingly, the Trustee may make distributions to, or for the benefit of, a Beneficiary for education, including tuition, room and board, supplies, books, lab fees, reasonable living expenses, and all other incidental costs, including travel for education at a public or private elementary school, middle school, high school, college, university, or graduate school, or other educational or vocational training. Notwithstanding these broad purposes, Settlers intend that a Beneficiary's educational

endeavors must be undertaken with a sustained and reasonable effort, and that advanced college degrees (or additional college degrees) be pursued primarily for the purpose of advancing in a job or career. Settlers do not intend that a Beneficiary become a perpetual student with regard to post-high school education. Rather, Settlers intend that a Beneficiary receive distributions for post-high school education so long as (a) the Beneficiary is pursuing his/her educational program with a reasonable degree of dedication; and (b) the educational program so pursued is reasonably destined to lead to socially productive employment. The Trustee shall consider the other income and resources of the Beneficiary (as provided in Article IX(F)), and shall have the sole discretion in determining the appropriate distributions for education, and the Trustee's judgment in this regard shall be final and binding on a Beneficiary.

(3) Living Expenses. Settlers believe that it is important in the development of a Beneficiary that such Beneficiary achieves self-sufficiency, and that such Beneficiary experiences the personal satisfaction and self-confidence that comes from such Beneficiary's own accomplishments. In general, Settlers intend that, once a Beneficiary completes his/her education, or while a Beneficiary is not pursuing a course of education as described in Paragraph (2) of this Section \_\_\_\_, such Beneficiary be employed, and that distributions from this trust for living expenses not impair the motivation of such Beneficiary to become an ethical, mature, responsible, self-sufficient, and productive adult as provided in Section (A) of this Article. If, in the judgment of the Trustee, a Beneficiary has financial difficulties because of his/her immaturity or lack of industry, Settlers intend that such difficulties be resolved by such Beneficiary and not by distributions from the trust; in such a case, Settlers intend the Trustee to be restrictive in making distributions for such Beneficiary's living expenses. On the other hand, if, in the judgment of the Trustee, a Beneficiary is unable to earn a reasonable income because of age, physical, or mental incapacity, or other circumstances that, in the judgment of the Trustee, are not caused by such Beneficiary's immaturity or lack of industry, Settlers intend that the Trustee may make distributions for the living expenses of such Beneficiary and those dependent upon such Beneficiary for care and support.

Notwithstanding anything contained herein to the contrary, if a Beneficiary has dependent issue and is committed to "stay-at-home" rearing and caring for such issue, the Trustee may, in the Trustee's discretion, make distributions for living expenses of such Beneficiary and those dependent upon such Beneficiary for their

care and support. Alternatively, the Trustee, in the Trustee's discretion, may make distributions to, or for the benefit of, a Beneficiary for childcare (in-home or outside of the home) in order that such Beneficiary may work outside of the home.

Settlors do not intend to impose any specific employment standard on a Beneficiary. Thus, a Beneficiary could be a schoolteacher, or a neurosurgeon, or a volunteer worker in a church. So long as the Beneficiary is either socially productive or unable to be so productive because of age, physical, or mental incapacity, or other circumstances that, in the judgment of the Trustee, are not caused by such Beneficiary's immaturity or lack of industry, the Trustee may make distributions for such Beneficiary's living expenses.

Settlors are aware that a Beneficiary may need differing amounts of distributions for living expenses at different times during the Beneficiary's lifetime. Accordingly, the Settlers authorize the Trustee to require the Beneficiary to maintain a budget of his/her living expenses and to provide such budget to the Trustee on a regular basis for the purpose of supporting discretionary distributions hereunder.

The Trustee shall consider the other income and resources of the Beneficiary (as provided in Article \_\_\_\_), and shall have the sole discretion in determining the appropriate distributions for living expenses, and the Trustee's judgment in this regard shall be final and binding on a Beneficiary.

33. Discretionary Income Distributions. Until the Division Date, the Trustee may, in the Trustee's discretion, accumulate the income and/or may distribute or apply any part or all of the net income of the trust as follows:

(1) Primary Beneficiaries and Secondary Beneficiaries. The Trustee, in the Trustee's discretion, may accumulate the income and/or may distribute or apply any part or all of the net income of the trust to, or for the benefit of, any one or more living members of a group consisting of Settlers' Primary Beneficiaries and Settlers' Secondary Beneficiaries, in such amounts (whether equal or unequal) and at such times as the Trustee, in the Trustee's discretion, determines is appropriate for the purposes set forth in Article \_\_\_\_\_, as those purposes may from time to time apply to such Beneficiaries. Prior to making any such distribution, the Trustee may but shall not be obligated to consult with either or both Settlers. In all events, the decision of the Trustee as to a discretionary distribution of income shall be final and binding on the Primary Beneficiary, Secondary Beneficiaries and Settlers; further provided, however, that income shall not be distributed or applied so as to discharge a legal obligation, including an obligation of support, of an individual acting as a Trustee hereunder. Notwithstanding this broad grant of discretion, it is Settlers' intention to provide first for the Primary Beneficiaries, and then, to the extent income is not needed for such Primary Beneficiaries, for the Secondary Beneficiaries. In addition, prior to making discretionary distributions of income to a Secondary Beneficiary, the Trustee shall consult with the Primary Beneficiary who is the parent of such Secondary Beneficiary as to whether such distribution is in the best interests of the Secondary Beneficiary; nonetheless, the decision of the Trustee as to a discretionary distribution to income to a Secondary Beneficiary shall be final and binding on the Primary Beneficiary and Secondary Beneficiary.

(2) \_\_\_\_\_ Foundation. In addition to the distributions of income authorized under Paragraph (1) of this Section, the Trustee, in its sole and absolute discretion, may distribute to the \_\_\_\_\_ Foundation income reasonably judged by the Trustee to be unnecessary to satisfy the intended trust distributions to the Primary Beneficiaries and Secondary Beneficiaries under Paragraph (1) of this Section; provided, however, the \_\_\_\_\_ Foundation must be in existence on the date of any such distribution and that the said \_\_\_\_\_ Foundation must then be a Charitable Organization as defined hereafter.

The Trustee shall assume no liability whatsoever for the exercise or nonexercise of its discretion to distribute income to the said \_\_\_\_\_ Foundation as provided in this Paragraph. The Trustee's judgment as to the appropriate distributions of income among the Primary Beneficiaries, Secondary Beneficiaries, and the \_\_\_\_\_ Foundation shall be final and binding on the said beneficiaries.

34. Substance Abuse/Incarceration.

(1) Substance Abuse of Incarceration. If the Trustee has actual knowledge that a Primary Beneficiary of Secondary Beneficiary of a trust uses or consumes an illegal drug, or abuses any legal drug of alcohol (collectively, "Substance Abuse"), or is incarcerated involuntarily (whether in a jail, prison, hospital, clinic, other treatment facility, electronic monitoring or house arrest, collectively "Incarceration"), the Trustee may suspend all distributions to or for the benefit of the Beneficiary pursuant to Section \_\_\_ of this Article, except for distributions for health care expenses of the Beneficiary as defined in Section \_\_\_ of Article \_\_\_. In addition, the Trustee may suspend all unitrust distributions to the affected Primary Beneficiary pursuant to Section \_\_\_ of this Article, and may suspend all requests for appointments by the Trust Protector pursuant to Section C of this Article.

(2) Trustee's Authority to Require Testing for Substance Abuse. If at any time the Trustee has actual knowledge that a Beneficiary engages in Substance Abuse, the Trustee may request in writing periodic, random drug or alcohol testing of such Beneficiary in such manner and at such times as the Trustee, in the Trustee's discretion, shall determine. The tests to be performed shall be those determined to be appropriate by a board certified physician or psychiatrist selected by the Trustee. If such Beneficiary fails any such drug or alcohol test, the rights of such Beneficiary to distributions under this Trust Agreement may, in the discretion of the Trustee, be suspended as provided in Section \_\_\_ of this Article. The cost of all drug or alcohol testing and medical examinations shall be paid from the trust held for the benefit of the affected Beneficiary.

(3) Reinstatement of Rights of Beneficiary After Substance Abuse. If the Trustee suspends the rights of a Beneficiary as a result of Substance Abuse as provided in Section \_\_\_ of this Article, the Trustee shall reinstate such Beneficiary's rights at such time as the Trustee determines after testing or medical examination that the Beneficiary does not suffer from Substance Abuse or, in the event the Beneficiary suffers from Substance Abuse, upon the written medical opinion of the Beneficiary's primary treating physician that the Beneficiary has successfully undergone treatment for his or her Substance Abuse. The Trustee, in the Trustee's discretion, may thereafter require periodic, random drug or alcohol testing for such Beneficiary as a condition of future distributions to or appointment by the Beneficiary.

(4) Reinstatement of Rights of a Beneficiary After Incarceration. If the Trustee suspends the rights of a Beneficiary as a result of Incarceration as provided in Section \_\_\_ of this Article, the Trustee shall reinstate such Beneficiary's rights at such time as the Beneficiary is no longer incarcerated.

(5) Release and Indemnification. Settlers do not intend by this Section \_\_\_ to make the Trustee responsible for or liable to anyone for a Beneficiary's actions, and Settlers specifically release the Trustee from any liability for any such actions and from all matters of any sort arising from or related to this Section \_\_\_. Settlers specifically direct that the Trustee have no duty whatsoever to inquire whether a Beneficiary engages in Substance Abuse or is Incarcerated as described in this Section \_\_\_. Settlers specifically direct that the trust indemnify and hold the Trustee harmless against any and all expenses or liabilities incurred with respect to any matter arising from or related to this Section \_\_\_, including, but not limited to, any action, suit or proceeding brought against the Trustee for any act or thing connected with this Section \_\_\_.

35. Chillin' Out Provisions.

2.5.3.1 The Trustee shall hold the entire balance of the trust estate, after making or providing for the payments and distributions set forth above, in trust, in accordance with the terms set forth in this paragraph 2.5.3.

2.5.3.1 Separate and apart from this Trust Agreement, the Trustor will have made arrangements for the whole body cryogenic suspension of himself and his pet dog, \_\_\_\_\_. As part of this arrangements, the Trustor will have designated a person or persons as his attorney-in-fact for health care purposes under the applicable statutes of the State of \_\_\_\_\_ relating to durable general powers of attorney for health care. The Trustor will have given instructions to such attorney-in-fact, either in a durable general power of attorney for health care or in another document, relative to medical treatment during the Trustor's last illness and delivery of the Trustor's remains the remains of \_\_\_\_\_ to an appropriate cryogenic facility. The Trustee is hereby directed to give full cooperation to the extent possible to said attorney-in-fact relative to such arrangements, and shall apply so much of the income and principal of the Trust Estate as is necessary to pay for the arrangements and services set forth immediately herein below. Any income not so expended shall be accumulated and added to principal.

(1) Physical delivery of the Trustor's and \_\_\_\_\_'s remains to such facility;

(2) Maintenance of such remains in a state best suited for cryogenic suspension in the intervening period of time between the Trustor's death and delivery to such facility;

(3) The costs of initial whole body cryogenic suspension of the Trustor;

(4) Cryogenic preservation and storage of the Trustor and \_\_\_\_\_ for the period set forth herein below. In the event whole body cryogenic suspension of the Trustor cannot be performed for any reason, the Trustor directs that to the extent possible, cryogenic neuropreservation be carried out instead if, in the Trustee's judgment, that procedure is practically possible, and the Trustee is directed to pay for all costs attendant to that procedure.

2.5.3.2 After the Trustor and \_\_\_\_\_ have been placed in a state of cryogenic suspension, the Trustee shall monitor the cryogenic facility in which they are placed on a periodic basis to be certain that the facility is maintaining them in the best manner known to science at that time. In the event Trustee determines that they, or either of them, is not being so maintained, the Trustee is hereby authorized to have them removed to another cryogenic facility which, in the Trustee's opinion, will provide superior service, no matter where in the world said facility may be located.

2.5.3.3 At such time as medical and cryogenic technology is available to revive the Trustor with reasonable safety in the Trustee's judgment, the Trustee shall authorize the revival of the Trustor and \_\_\_\_\_. Pending such event, the Trustee shall continue to hold and manage the Trust Estate and shall apply so much of the income and principal thereof as is necessary, in the Trustee's judgment, to properly maintain the Trustor and \_\_\_\_\_ in cryogenic suspension. Any new income not so used shall be accumulated and added to principal.

2.5.3.4 At the time of such revival, if in the Trustee's judgment the revival has been successful and the Trustor has the capacity to properly manage his own financial affairs, the Trustee shall deliver the remaining trust estate to the Trustor and the trust shall terminate. After the revival of the Trustor, if, in the Trustee's judgment, the Trustor is not able to properly care for himself or his financial affairs, the Trustee shall continue to apply income and principal of the Trust Estate for the Trustor's benefit on the same basis as is set forth in paragraphs 2.1 and 2.2 above in the event of the Trustor's incapacity. Any net income not so used shall be accumulated and added to principal.

2.5.3.5 If the trust set forth herein must terminate by virtue of expiration of the perpetuities period described in paragraph 2.6 hereof prior to the successful revival of the Trustor, this Trust shall terminate and all assets of the trust estate shall be delivered forthwith to \_\_\_\_\_.



2.5.3.6 In the event of the death of the Trustor under circumstances that would preclude the cryogenic suspension of the Trustor (whether whole body or neuropreservation only) because of the remoteness of the Trustor at the time of death from a cryogenic facility, an accident causing death which renders the Trustor's remains unsuitable for cryogenic suspension, or any other like circumstances, the trust provided for in this paragraph 2.5 shall not be established and the assets of the trust estate shall be distributed in the following manner:

# **A POTPOURRI OF NEWER SD TRUST LAWS RELEVANT TO A MAIN STREET PRACTICE**

**Presented by**

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***A POTPOURRI OF NEWER SD TRUST LAWS  
RELEVANT TO A MAIN STREET PRACTICE***

***By Patrick Goetzinger  
SD State Bar Annual Meeting  
Trust CLE, June 17, 2010***

**I. Introduction - Is a trust practice still relevant today?**

**A. Remember when we were told:**

1. The repeal of the Federal Estate Tax; or
2. The increase of the applicable exclusion amount or unified credit would decimate an estate planning practice; or
3. Trust preparation would become a DIY commodity as a result of the internet and the availability of canned trust documents at the punch of a button?
4. We were told our trust practice would wither on the vine and someday become obsolete.

**B. A mix of time tested realities and new statistics contradict what we were told.**

1. An active trust practice is as important today as ever due to the human challenges our clients present to us on a daily basis.
2. Trusts are as relevant in 2010 as they were in 1556 when the rector of Buckingham in Kent, England observed:
  - a. “If your children and relations are notoriously vicious and debauched...do not abdicate or cast them off...but make provision for them in trust in such manner and with such circumstance as may relieve their necessities, but not their lusts.” *A Theological Disclosure of Last Wills and Testaments*, William Assheton (1556).
  - b. Assheton’s 1556 observation still reverberates in 2010. The human challenges thrust upon us by clients and their circumstances on a daily basis provide ample motivation to include a trust discussion among the options to grant our clients peace of mind.
  - c. The causes of our client’s angst calling for a trust solution include:
    - i Tax considerations;
    - ii A litigious society;
    - iii Asset protection objectives;
    - iv Aging clients who live longer;
    - v Blended families;
    - vi Multiple marriages;
    - vii Relationships outside of wedlock;
    - viii Media attention to celebrity estates;

- ix Demographic and societal trends; and
- x The Warren Buffet Theory of estate planning.
  - Give your children enough to do something, but not so much they do nothing. Give the rest to charity.
- 3. In SD, the numbers associated with trust assets managed or administered by SD based trust companies reveals a deep affection among trust and estate lawyers who find our state very appealing as a home for their clients' trusts and trust companies.
  - a. In 1996, SD had less than 5 state chartered trust companies with less than \$1 *billion* in trust assets.
  - b. By 2001, SD had 13 state chartered trust companies with \$12.7 *billion* in trust assets.
  - c. As of December 31, 2009, SD had 39 state chartered trust companies (and 1 state chartered equivalent trust company grandfathered in from old rules predating 1996) with \$57.3 *billion* in trust assets.
    - i As of the same date, the Division of Banking had 9 additional charter applications pending for new trust companies who want to call SD home.
    - ii The numbers above don't include national chartered banks, such as Wells Fargo & US Bank among several others, which have an additional estimated \$640 *BILLION* in trust assets in SD (using numbers provided in May 2009).
    - iii As of May 2009, assets in trust for the entire US were estimated at \$1.2 trillion.

#### C. Why SD?

1. It is no accident SD has become the preferred destination for trust assets and state chartered trust companies.
2. In 1996 Governor Janklow appointed the Governor's Task Force on Trust Administration Review and Reform ("Task Force"). The Trust Task Force was critical to the growth of SD's trust business.
3. Active attention to SD's trust statutes and regulatory environment by the Task Force (with an assist from the RPPT Section of the State Bar) and active marketing of SD as a destination by many has resulted in the numbers recited above.
4. As acknowledgement of the Task Force's efforts, SD earned the #1 ranking as the top trust jurisdiction in the US by *Trust & Estates Magazine*, (January 2007) – the last such ranking performed by a national publication known to this author.
5. The reason for SD's #1 ranking include the following features in SD law:
  - a. No rule against perpetuity which allows for perpetual trust duration.

- i In contrast to other states, SD is NOT a “Johnny come lately” to the repeal of the RAP.
  - b. We are a no tax or low tax oasis. SD has:
    - i No state income tax, capital gains tax, dividend tax, interest tax, or intangible tax;
    - ii Low bank franchise tax; and
    - iii Lowest insurance premium tax.
  - c. Modern, yet time tested, premium trust laws in the following areas:
    - i Directed and delegated trusts;
    - ii Trust protector statutes;
    - iii Privacy statutes;
    - iv Trust reformation, modification, decanting and virtual representation statutes;
    - v Asset protection for third party discretionary trusts; and
    - vi Domestic asset protection trust or self-settled trust statutes.
  - d. Trust company formation rules and regulations are balanced.
    - i SD law balances maintaining integrity, giving back to SD and a firm, but flexible application and regulatory environment for companies who seek to form and maintain a state chartered public or private trust company in SD.
    - ii The SD Division of Banking oversees state chartered trust company applications and monitoring.
    - iii These rules are beyond the scope of this outline, but see the article that appeared in the May 28, 2010, edition of the Financial Advisor magazine entitled, *Landmark Changes For South Dakota Trusts*.
      - The web address is: <http://www.fa-mag.com/fa-news/5606-landmark-changes-for-south-dakota-trusts.html>.
- C. SD Trust law. It’s not just for the ultrawealthy.
  - 1. What the world has discovered about SD trust statutes bears closer examination by main street lawyers.
  - 2. The relevance of SD trust innovations apply equally as well to main street lawyers offering retail, off the shelf, conventional trust products as they do for the Madison Avenue lawyers offering specialized, boutique trust products.
  - 3. SD offers main street lawyers:
    - a. More tools to minimize the risk of a trust going wrong; and
    - b. More tools to fix a trust gone wrong.
    - c. More tools to tailor a trust to meet the challenges presented by today’s and tomorrow’s clients.

- d. The tools and techniques discussed below are just as useful for bread and butter trusts as they are for dynasty and perpetual trusts. They will work for:
  - i Testamentary trust for the minor children;
  - ii Credit Shelter Trust;
  - iii Marital & QTIP Trusts;
  - iv ILITs;
  - v IRC § 2503(c) Minor's Trust; and
  - vi Any other trust you can think of.

## II. SD Situs Statutes.

- A. SD law defining when a trust is conclusively governed by SD law, or situated in SD, is the North Star to navigating SD trust law and guides others to SD for their trust planning.
- B. Application of the premium SD trust provisions is tied to a conclusive, unambiguous determination that SD trust law applies.
- C. The statutes defining whether a trust has SD situs are codified at SDCL § 55-3-39 to 43.
- D. Pursuant to SDCL § 55-3-39, a trust stating SD law applies to the trust is valid, effective and conclusive if all of the following are true:
  - 1. Some or all of the trust assets are deposited in SD or physical evidence of such assets is held in this state;
  - 2. A trustee is a qualified person; and
  - 3. The administration, for example, physically maintaining trust records in SD and preparing or arranging for the preparation of and income tax return filed by the trust.
  - 4. If all three requirements are met, SD and its courts will also have jurisdiction over a trust even if it is created in a foreign jurisdiction.
- E. SDCL § 55-3-41 defines a qualified person (aka, the trustee) as:
  - 1. An individual who resides in SD,
    - a. whose true and permanent home is SD,
    - b. who does not have a present intention of moving from SD, and
    - c. who has the intention of returning to SD,
    - d. except for
      - i brief intervals,
      - ii military service,
      - iii attendance at training or school, or
      - iv absences for good cause shown.
  - 2. A trust company
    - a. organized under title 51A (private or public trust company), or

- b. under federal law, and has SD as its principal place of business.
3. A bank or savings association that possesses and exercise trust powers, has SD as its principal place of business, and deposits insured by FDIC.
- F. Practical considerations in selecting a trustee for the bread and butter, run of the mill trusts used in a main street practice.
  1. If a “qualified person” is not appointed as a trustee or a co-trustee, you risk losing SD jurisdiction over the trust.
  2. Losing SD jurisdiction deprives you of utilizing the array of SD trust laws available to achieve flexibility or desired protections.
  3. Losing SD situs also may expose the trust to state taxes that are not present in SD.
  4. Beware of clients who insist having a relative from CA, MN or another notoriously unfriendly tax jurisdiction, as the sole trustee.
  5. Also beware of the financial advisor pushing their out of state trust company as the trustee of client trusts.
    - a. Instead, make the financial advisor a friend by recommending a qualified SD trustee, but appoint the financial advisor, or her company, as the investment trust advisor. See discussion, *infra*, Article V(E).
    - b. If an institutional trustee is appointed, but the trust instrument does not exclude investment decisions from the trustee’s responsibility, the institution will typically sweep the investments from the financial advisor who assisted in building the account value, and bring the investments under the trustee’s control.
    - c. By adding language to the trust that appoints the financial advisor as the investment trust advisor, the financial advisor retains investment responsibility over the trust assets. *Id.*

### III. Domestic Asset Protection Trusts (“DAPT”).

- A. Terminology & Legalese mask a revolutionary concept.
  1. DAPTs are also known as self settled trusts. A self settled trust means:
    - a. An individual can transfer assets to a trust she forms;
    - b. Name herself as a beneficiary; and
    - c. Protect the assets in the trust from her creditor claims.
  2. 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.
    - a. If the trust complies with SD spendthrift statutes, the assets will be protected from the third parties creditors.
    - b. See discussion, *infra*, Article IV.

3. This revolutionary concept is codified in SDCL Chap. 55-16, entitled, “Qualified Dispositions In Trust.”
  - a. This unfortunate name is confusing and disorienting.
  - b. To the uninitiated, it camouflages a very, very effective trust tool.
  - c. Mainstream discussion of DAPTs and self settled trusts does not include the terminology “qualified dispositions in trust.”
  - d. You will not find the terms “self settled trust” or “domestic asset protection trust” anywhere in SDCL Chap. 55-16.
  - e. SD’s legislation is a classic example of a disconnection between brand marketing and code names.

#### B. Background.

1. The general rule nearly forever has been that creditors of an individual who created a trust could reach the assets of the trust to satisfy their claims if the individual retained the right to benefit from the trust. Restatement of Trusts (Second), Section 156(2).
2. In order to protect an individual’s assets from creditors, but also benefit from those assets in trust, the individual had to go offshore and form a trust under the laws of a foreign jurisdiction.
  - a. Offshore trust planning gained popularity, in some circles, primarily due to this feature that prior to 1997 was not offered in the US.
  - b. Going off shore, though exotic and alluring, had its own risks.
3. In 1997, Alaska was the first state to authorize DAPTs. Delaware was the next. More states have passed similar legislation, but SD, AK and DE are universally regarded as “The Big Three” among DAPT states.
4. After a long period of deliberation and due diligence by the Task Force, SD authorized DAPTs in 2005. While not as exotic as the Cayman or Cook Islands, individuals can now achieve in SD what was previously thought only possible offshore.

#### C. Qualifying a Trust as a SD DAPT.

1. More terminology.
  - a. The statute references “transferor”.
  - b. A transferor is also known as a settlor or grantor.
  - c. 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).
2. 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).
3. “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 SD DAPT.
4. “Qualified person” is defined in SDCL § 55-16-3.
    - a. Simply stated, a qualified person is a trustee qualified to act under SD law.
    - b. A qualified trustee is:
      - i An individual, other than the transferor, who resides in SD; or
      - ii An entity who is authorized by SD to act as a trustee, such as a public or private trust company as described in SDCL § 55-3-41; AND
      - iii Who meets all the requirements of the SD situs rules set forth in SDCL § 55-3-39, which provide the following conditions:
        - Some or all of the trust assets are deposited in SD or physical evidence of such assets is held in this state; and
        - The administration, for example, physically maintaining trust records in SD and preparing or arranging for the preparation of and income tax return filed by the trust.
        - See Discussion, supra, Article II(E).
      - iv 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.
      - v Furthermore, the grantor can appoint trust advisors, trust protectors and other fiduciaries defined in SDCL § 55-1B-1(4). See also discussion, infra, Article V. This feature allows flexibility by allowing the appointment of a SD trustee but involvement by the family members or other trusted advisors who may:
        - Remove and appoint trustees and trust advisors;
        - Direct, consent to, or disapprove trust distributions; or
        - Invest the assets of the trust.
        - In certain cases, the transferor can hold the powers described above. See SDCL § 55-16-5.
  5. A “trust instrument” is defined in SDCL § 55-16-2. To qualify as a SD DAPT, the trust instrument must:
    - a. Expressly incorporate SD law to govern the validity, construction, and administration of the trust;
    - b. State the trust is irrevocable; and
    - c. Contain a spendthrift clause.
    - d. The statute is handy in giving you precise language to use to satisfy these conditions. SDCL § 55-16-2(1) – (3).

- e. The statute provides specific examples of language that may be contained in the trust instrument without spoiling the irrevocability of the trust instrument. See 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.
  - f. While the transferor may retain some measure of control over the trust and its assets, that control will not expose the trust assets to the transferor’s creditors 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. Creditor Protections.
- 1. 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.
    - a. This rule taps into the concepts discussed in fraudulent conveyance statutes found in the Uniform Fraudulent Transfer Act, SDCL Chap. 54-8A.
    - b. **ETHICAL CONSIDERATION:** The attorney should confirm with the client or counsel the client on existing, pending or suspected claims against the client.
  - 2. Additional creditor protections are codified in SDCL § 55-16-10. The 3 year/1 year Rules.
    - a. 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).
      - i 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:
        - three years of the transfer to the DAPT, or
        - one year after the creditor discovers the transfer of assets to the DAPT, subject to very specific proof requirements. See SDCL § 55-16-10(1)(b)(i) & (ii).

- b. If a creditor becomes a creditor AFTER the assets were transferred to a DAPT, a fraudulent transfer action can be brought within three years after the transfer is made. SDCL § 55-16-10(2).
  3. The creditor has the burden of proving they were defrauded by clear and convincing evidence. Id.
  4. The creditor cannot sue the trustee, trust advisor or trust preparer. SDCL § 55-16-12.
  5. And if a creditor does sue, the court may award attorney fees. SDCL § 55-16-13.
- E. Notwithstanding all of the above, DAPTs will not protect assets from:
  1. Alimony;
  2. Child support;
  3. Property settlement division in a divorce; or
  4. Claims for death, personal injury or property damage on or BEFORE a transfer to the DAPT.
- F. Even if a creditor has a valid claim, SDCL § 55-16-16 provides important guidance on what, precisely, is at risk.
  1. The assets transferred to 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 the trust assets.
  2. 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.
- G. CAUTION:
  1. It is unsettled how an out of state court will view DAPTs.
  2. Will out of state courts declare DAPTs void against public policy?
- H. Tax considerations are beyond the scope of this outline. However, generally, a qualified disposition:
  1. Is not a completed gift for gift tax purposes;
  2. Does not remove the assets from the transferor's estate for federal estate tax purposes; and
  3. Is probably a grantor trust for income tax purposes.
  4. Don't forget about the generation skipping transfer tax.
- I. Join the revolution! Form a DAPT. Clients predisposed to use a DAPT with a little nudge from their advisor may be:
  1. Professionals;
  2. Business owners;
  3. Farmer/Ranchers;

4. Any client who realizes a significant cash infusion after the sale of a business, land, investments or other assets;
5. The liquid client; or
6. Family vacation home or cabin owner.

IV. Spendthrift & Third Party Discretionary – Support Statutes.

- A. The Spendthrift Trust provisions were previously codified in SDCL § 55-1-16 to 19.
  1. These statutes were repealed in 2007.
  2. They were replaced in 2007 by the Third Party Discretionary – Support Statutes, codified in SDCL § 55-1-24 to 43.
  3. The new rules offer clients a spendthrift trust on steroids.
  4. Or, creditor protections may be offered beneficiaries and grantors even if the trust lacks traditional spendthrift language – the accidental spendthrift trust phenomena.
- B. Why change SD’s longstanding spendthrift statutes?
  1. Courts have new authority available to interpret trust provisions. They are:
    - a. The Restatement of Trusts (Third); and
    - b. The Uniform Trust Code.
    - c. This new authority presents a decidedly pro-creditor rights position with regard to accessing trust assets to satisfy beneficiary creditor claims.
  2. This new authority is in sharp contrast with common law and the Restatement of Trusts (Second).
  3. Authors of the new statute and the Task Force sought to codify common law and the approach taken by the Restatement of Trusts (Second) and specifically reject the approach taken by the Restatement of Trusts (Third) and the Uniform Trust Code. SDCL § 55-1-25.
  4. For an in depth analysis of the issues addressed in this Section B, see *DAPTs Which States Offer the Best Situs?*, Mark Merric (2008) & *Where Should You Situs Your Trust? A Look at SD’s New Third Party Discretionary – Support Statute*, Merric, Becker & McDowell (2007).
- C. Note the trusts discussed in this Article are third party beneficiary trusts.
  1. That is, they are formed by a grantor for the benefit of someone else.
  2. Third party beneficiary trusts are distinguished from self settled trusts or DAPTs. See Article III, supra.
- D. A common law discretionary trust with a spendthrift provision will protect the trust assets from the beneficiary’s creditor claims. See Merric Article.

1. A discretionary trust is one that does not mandate distributions to the beneficiary.
  2. The trustee retains the discretion over distributions to the beneficiary.
- E. A pure support trust typically does not protect the trust assets from the beneficiary's creditor claims.
1. A support trust is one that mandates the trustee to make distributions to the beneficiary.
  2. However, under the new SD statutes, the beneficiary's distribution interest defined by the trust terms can be classified in one of three categories and the trust can be bifurcated by the interests created.
    - a. 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, 39.
    - b. 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, 37, 41.
- F. A distribution beneficiary is a beneficiary of a trust who is eligible to receive distributions of trust income or principal. SDCL § 55-1-24(3).
- G. A distribution interest is held by a distribution beneficiary. SDCL § 55-1-24(4).
1. A distribution interest may be a current interest or a future interest.
  2. A distribution interest may be classified in one of three ways:
    - a. A mandatory interest;
    - b. A support interest; or
    - c. A discretionary interest.
- H. A mandatory interest is defined as a distribution interest where the timing of any distribution must occur within one year from the date the right to the distribution arises, and the trustee has no discretion in determining whether a distribution shall be made or the amount of the distribution. SDCL § 55-1-38(1).
1. SDCL § 55-1-40(1) contains sample language creating a mandatory interest.
  2. SDCL § 55-1-42 contains additional rules related to a mandatory interest.
- I. A support interest contains mandatory language such as "shall make a distribution" and is coupled with a standard capable of judicial interpretation. SDCL § 55-1-38(2).
1. See also SDCL § 55-1-38.1 & 42 for additional clarification.
  2. SDCL § 55-1-40(2) contains sample language creating a support interest.

- J. A discretionary interest is any interest where a trustee has discretion to make or withhold a distribution. SDCL § 55-1-38(3).
    - 1. Evidence of a discretionary interest includes use of the terms:
      - a. “may make a distribution”; or
      - b. “shall make a distribution in the trustee’s sole discretion”. Id.
      - c. SDCL § 55-1-40(3) contains more sample language creating a discretionary interest to guide the trust drafter.
    - 2. SDCL § 55-1-43 contains rules that apply only to a discretionary interest.
  - K. Additional creditor protection features include:
    - 1. Neither a distribution interest nor a remainder interest is relevant in the equitable division of marital property. SDCL § 55-1-30.
    - 2. In the event a party challenges the settlor’s or beneficiary’s influence over the trust in an attempt to gain access to trust assets, several factors are disregarded in determining if the beneficiary is exercising dominion and control over the trust. SDCL § 55-1-32.
    - 3. 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.
  - L. Clients are provided with more tools to protect trust assets from a beneficiary’s creditors, predators, in-laws and out-laws, even if the trust fails to contain spendthrift language.
- V. Directed Trusts. Excluded Fiduciaries. Trust Protectors. Trust Advisors.
- A. Traditionally, when a trustee is appointed, it is expected the trustee will be a full service trustee.
    - 1. The trustee will perform all duties associated with the administration of the trust, investment of trust assets, and carrying out the grantor’s instructions on distributions to the trust beneficiaries.
    - 2. Tradition is redefined under SD trust law.
  - B. SD law permits a trust to be designed in a way that carves up trustee powers and functions and delegate or assign specific powers or functions to other individuals who are not the trustee. SDCL Chap. 55-1B.
  - C. This flexibility allows for the appointment of a SD trustee (aka qualified person) with the application of SD law to govern the trust, but the appointment of individuals from the grantor’s family, investment team, and, in some cases, the grantor himself to make investment, distribution and other trust management decisions in the capacity of a trust advisor or a trust protector.
  - D. The application of these statutes goes beyond trust administration and can be applied to any situation where a “fiduciary” is appointed. A fiduciary is defined in SDCL § 55-1B-1(4) as:

1. A trustee;
  2. A custodian under any instrument;
  3. An executor;
  4. An administrator;
  5. A personal representative of a decedent's estate; or
  6. Any other party acting in a fiduciary capacity (including a trust advisor, trust protector or trust committee).
  7. Thus, you may utilize these concepts in a probate, conservatorship, and durable power of attorney.
    - a. Example: Business owners appoints spouse as PR, but wants his business partner to be responsible for management of his business interests.
    - b. Will appoints spouse as PR, but states she is an excluded fiduciary for the testator's business interests.
    - c. Will also states the business partner is the "trust protector" (or its equivalent in the probate setting) limited in authority to manage the testator's business interests.
- E. An excluded fiduciary is defined in SDCL § 55-1B-1(5) as:
1. Any fiduciary excluded from exercising certain powers as spelled out in the trust document.
  2. The excluded powers can instead be exercised by the grantor, trust advisor, trust protector or trust committee.
  3. The liability of an excluded fiduciary is limited as set forth in SDCL § 55-1B-2.
- F. A trust advisor can be either an investment trust advisor, or a distribution trust advisor.
1. An investment trust advisor is a fiduciary given authority by the trust to exercise all or any portion of the powers relating to trust investments. SDCL § 55-1B-1(6), 9 & 10.
  2. A distribution trust advisor is a fiduciary given authority by the trust to exercise all or any portion of the distribution powers set forth in the trust. SDCL § 55-1B-1(7), 9, 11.
  3. The duties of a trust advisor can also be carried out by a trust committee. SDCL § 55-1B-5.
- G. A trust protector, interestingly, is not labeled a fiduciary in SDCL § 55-1B-1(2). *But see* SDCL § 55-1B-1(4) which includes trust protector in the definition of "fiduciary".
1. A trust protector may be granted a wide array of powers, as set forth in SDCL § 55-1B-6.
  2. The powers listed provide a tremendous amount of flexibility:

- a. in administering the trust,
  - b. appointing trustees, trust advisors, trust protectors,
  - c. modifying the trust,
  - d. changing the trust situs, and
  - e. many more applications.
- H. The term “directed trust” is not defined in this chapter, even though the Code Commission labeled the Chapter “Directed Trusts”.
1. It is a term of art. The Directed Trust label has gained popularity in the language of our profession.
  2. In a directed trust, the trustee generally has no discretionary investment duties and distribution duties. *Delegated vs. Directed Trusts*, King & McDowell, *Trust & Estates Magazine*, p. 26, 27(July 2006).
  3. A directed trustee generally has no other duty but to follow the directions of the trust advisor(s) or trust protector. *Id.*
  4. The trustee in a directed trust is directed to invest and/or distribute trust assets by trust advisors. *Id.*
  5. The trustee in a directed trust may be relieved of trust management tasks or is directed in the performance of trust management functions by a trust protector. *Id.*
  6. The trustee ensures the grantor’s intent as expressed in the trust is being followed. *Id.*
  7. The directed trust must be distinguished from a delegated trust.
- I. A delegated trust is one in which the trustee has contracted with a third party to perform some or all of the trustee’s discretionary investment management functions. *Id.*
1. The trustee of a delegated trust may retain some investment duties. *Id.*
  2. The trustee may also retain some investment monitoring functions. *Id.*
- J. These rules allow for the appointment of a pure administrative trustee, and charging trustee fees commensurate with performing only administrative functions.
- K. Planning options abound.
1. Encourage discussion with your client about the different functions traditionally reserved for the trustee that might be delegated to family, friends, advisors or anyone whose judgment the grantor trusts.
  2. Explore how a directed trust might work with your local institutional trustees.
    - a. What is the fee structure if the institutional trustee does not have fiduciary responsibility for investments?
    - b. Are family members better suited than the institutional trustee to make distribution decisions?



3. Explore the use of investment or distribution committees.
4. Relieve family members from the administrative grind of managing a trust by appointing an administrative trustee.
  - a. Reserve the paper chase to the professionals.
  - b. Mix & match your family/advisors strengths.
  - c. Specialization and the art of delegation is codified in SD.

VI. IRA Exemption Increased to \$1 Million.

- A. Prior to 2007, a person could only exempt \$250,000 in IRA funds from creditor claims.
- B. Effective in 2007, the IRA exemption amount was increased to \$1 million. SDCL § 43-45-16.
- C. Under SD trust law, a “person” is defined as “an individual..., a trust..., or two or more persons having a joint or common interest.” SDCL § 55-4-1.
- D. A SD trust that owns an IRA may protect up to \$ 1 million as exempt from creditor claims. This opens a world of possibilities, particularly the formation of a Self-Directed IRA Trust.
- E. EXCEPTION: IRAs are not exempt from the claims of the state and its subdivisions.

VII. Pet Trusts.

- A. Yes. Pet trusts. They are codified at SDCL § 55-1-20 thru 22.
- B. Trusts for the sole and exclusive benefit of a pet are valid in SD. SDCL § 55-1-21.
- C. To carry out the grantor’s intentions regarding Fido, SD law allows:
  1. A liberal construction of trust terms;
  2. Presumptions in favor of protecting Fido; and
  3. Admission of extrinsic evidence.
- D. When forming a pet trust, consult SDCL § 55-1-22 for issues to address in the trust instrument.
  1. The trustee need not actually care for the pet. A caretaker can be appointed.
  2. Unless the trust terms extend the trust to care for Fido’s issue, the trust will terminate and be distributed according to the trust terms or the statutory preference set forth in SDCL § 55-1-22(2), unless extrinsic evidence of the grantor’s intent demonstrates otherwise.
  3. The court can reduce the amount held in trust if it is excessive. SD may have lost Leona H’s pet trust as a result (probably not).

VIII. Privacy Protections.

- A. The general rule is court records are available to the public.
- B. Understandably, subjecting the terms and conditions of a grantor's trust, the value and nature of trust assets, and all manner of trust tidbits to an inquiring press or public would chill enthusiasm for any jurisdiction that did not respect absolute privacy of the trust and grantor affairs.
- C. SD expressly acknowledges the importance of privacy regarding trust affairs in SDCL § 21-22-28, which seals court records upon proper petition and order of the court.
- D. In light of the recent headlines regarding the press' access to court records in civil litigation matters (See e.g. current Bear Country litigation matter), it is necessary that SD law expressly state court filings involving trusts may be sealed.
- E. Trust filings occur in both court supervised and non-supervised matters. Grantor's can rest assured that even if a trust matter becomes litigated, or court supervised, the file may be sealed against prying eyes and inquiring minds who have no interest in the trust.

IX. Grounds for Removal of Trustee.

- A. SD has codified the basis for removing a trustee in SDCL § 55-3-20.1.
- B. Without excluding any method of removing a trustee granted by other remedies, or as provided in the trust, a grantor, her agent, another co-trustee, qualified beneficiaries and the court on its own initiative may seek the removal of a trustee.
- C. The grounds for removing a trustee include, without limitation:
  - 1. A serious breach of the trust;
  - 2. Lack of cooperation among co-trustees to the extent it impairs the administration of the trust;
  - 3. Unfitness, unwillingness or persistent failure to administer the trust and a determination removal of the trustee best serves the interest of the beneficiaries;
  - 4. A substantial change of circumstances where removal best serves the interests of all beneficiaries and is not inconsistent with a material purpose of the trust;
  - 5. Removal is requested by all beneficiaries where removal best serves the interests of all beneficiaries and is not inconsistent with a material purpose of the trust;
  - 6. A suitable co-trustee or successor trustee must be available; or
  - 7. The trustee merges with another institution, or the location and place of administration of the trust changes and removal best serves the interests

of all beneficiaries and is not inconsistent with a material purpose of the trust.

X. Approval of Trustee Accounting.

- A. Achieving finality annually through approval of a trustee's accounting is important client's and trustees. SDCL § 55-3-45 states:
  - 1. If a trust is not subject to court supervision under SDCL Chap. 21-22; and
  - 2. If no objection has been made by a distribution beneficiary within 180 days after a trustee's accounting has been mailed to the beneficiary;
  - 3. The beneficiary is deemed to have approved the accounting.
  - 4. Exceptions are:
    - a. Fraud;
    - b. Intentional misrepresentation; or
    - c. Material omission.
  - 5. SDCL § 21-22-30 applies to court supervised trusts.
- B. The legal effect of a deemed approval of a trustee's accounting is the trustee's release and discharge from all liability to the beneficiaries as to all matters set forth in the accounting.
- C. An accounting means:
  - 1. Any interim or final report or statement;
  - 2. Reflecting all transactions, receipts and disbursements during the reporting period;
  - 3. A list of assets as of the end of the period covered by the report; and
  - 4. Written notice to the beneficiary of the provisions of this section.
- D. It is incumbent upon the trustee to include written notice of this section in the report to take advantage of the protections.
- E. It is incumbent upon the beneficiary to inquire or object timely in order to preserve his/her claims.

XI. Useful trust law additions effective July 1, 2010.

- A. Limitations on contesting a decedent's revocable trust.
  - 1. A new section will be added to SDCL Chap. 55-4 that establishes time frames within which a trust contest may be brought. SD Legislative Session 2010, SB 103, Section 1.
  - 2. In order to contest the validity of a revocable trust upon the death of the grantor, the action shall be commenced within the earlier of:
    - a. One year after the grantor's death; or

- b. 60 days after the trustee sent a copy of the trust instrument with information about the existence of the trust, the trustee's name and address, and the time allowed for commencing a proceeding.
  3. Trustee protections for distributing trust assets are established, with exceptions.
  4. In the event a beneficiary receives assets from a trust after a successful contest, the beneficiary is required to return the assets. If he/she does not, the beneficiary may be held liable for all costs, including attorney fees, incurred for the recovery of the distribution.
- B. Creditor claims cut-off procedure for revocable trusts.
1. A new section will be added to SDCL Chap. 55-4 that establishes a procedure to cut-off creditor claims after the death of a settlor. SD Legislative Session 2010, SB 103, Section 12.
  2. This new statute may eliminate the need for a probate of the settlor's estate if the only purpose for the probate was to obtain the protections of the creditor claim cut-off rules of the Uniform Probate Code.
  3. The new section sets forth the rule for suspected creditors and unknown creditors, which are substantially similar to the UPC approach.
  4. Creditor claims are barred if no claim is filed within the applicable period.
  5. The new section also gives specific instruction to creditors on properly presenting claims to a trustee.
  6. The new section provides instruction on how to deal with contingent claims or claims that have not yet matured.
  7. A trustee may not be held liable for nonnegligent or nonwillful failure to give notice to a particular creditor.
    - a. This is more protection than is provide to personal representatives under the UPC.
  8. The new section sets forth the priority rules if the trust assets are not sufficient to pay all creditor claims and trust expenses.
  9. If a creditor is wrongfully paid, it must return the payment. If the creditor refuses, the creditor may be held liable for all costs, including attorney fees, incurred for the recovery of the distribution.

## XII. Miscellaneous.

- A. It is assumed the reinstatement of the defense of laches in connection with trust modification, reformation or termination actions pursuant to SDCL § 55-3-23 thru 29 shall be discussed by other CLE speakers. See SDCL § 55-3-30.1.

1. A statute was enacted to make it clear the holding in In the Administration of Young Revocable Living Trust, 2008 SD 43, is not available to defeat the ability to modify, reform or terminate a trust.
  2. As can be imagined, the concept of barring an action involving a perpetual duration or dynasty trust by assertion of the laches defense would be discomfoting.
- B. It is assumed new rules enacted this past legislative session regarding trust certificates shall be discussed by other CLE speakers. SD Legislative Session 2010, SB 103, Section 8, 9 & 10, amending SDCL § 55-4-44 & 45.

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# Program Evaluation

## TRUST LAWS CLE

Please rate the following on a scale of one to five. Five being Excellent, and one being Poor.

1. Overall the program was: 5 4 3 2 1

2. Program Evaluation:

Grossenburg & Akkerman – How to Change Irrevocable Trust  
in South Dakota 5 4 3 2 1

Voss – Who is Entitled to a Copy of the Trust and When 5 4 3 2 1

Moe – Observations on the Current Status of the Federal Estate Tax 5 4 3 2 1

Donohue – The Use of Trusts to Incentivize the Beneficiary 5 4 3 2 1

Goetzing – A Potpourri of Newer o) u O k ..... 5 4 3 2 1

.....U o h

3. Program Materials: 5 4 3 2 1

Comments:

4. Facility: 5 4 3 2 1

Comments:

5. Any other comments about programming, scheduling, etc?