South Dakota's Situs Advantages Over California

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In the ever-evolving landscape of wealth management and estate planning, the choice of a trust situs plays a pivotal role in safeguarding assets, ensuring seamless wealth transfer, and preserving financial legacies for future generations. As the global economy becomes increasingly interconnected, individuals and families are presented with a myriad of options when selecting the jurisdiction in which to establish their trusts. In this paper, we will look at California and South Dakota, one of the most populous states and one of the least populated states. As you will see, more isn't always better.

The trust situs, or the jurisdiction in which a trust is administered, holds far-reaching implications for the overall success and effectiveness of trust structures. The dynamism of international laws, tax regulations, and legal frameworks across jurisdictions necessitates a strategic and informed approach to trust situs selection.

There are many elements that define a trust-friendly trust situs, including favorable legal and regulatory environments, robust asset protection mechanisms, tax considerations, and the ability to adapt to changing circumstances. By understanding the nuances of different jurisdictions, stakeholders can make informed decisions that align with their unique objectives and contribute to the creation of enduring structures capable of withstanding the tests of time and regulatory evolution.

Among the array of jurisdictions offering trust services, South Dakota has emerged as a premier destination, offering a unique set of advantages that fortify the foundations of wealth preservation and succession planning. In contrast, California has postured itself in opposition to the ideals of wealth preservation and legacy transfer among the ultra-high net worth segment.

In the pages that follow, we will explore elements of South Dakota and California trust law and provide insights to empower individuals and trusted advisors to navigate the complexities of the global financial landscape with confidence, ensuring that their chosen trust situs not only meets their immediate needs but also stands resilient in the face of future challenges.

RULE AGAINST PERPETUITIES (RAP) AND DYNASTY TRUSTS

While South Dakota was a trailblazer in 1983 by abolishing the Rule Against Perpetuities (RAP) and allowing trusts to last perpetually for all assets, California's approach to RAP has not been as progressive. Prior to 1986, only Idaho, South Dakota, and Wisconsin had abolished the Rule. However, with the advent of the GST tax exemption, perpetual trusts became more attractive, and these states gained a relative advantage in attracting new business. This did not go unnoticed. Since then, nineteen states and Washington D.C. have either fully abolished the Rule or have abolished it subject to some statutory limitation, such as requiring that the trust contain a power of sale in the trustee, that the trust clearly opt out the Rule, or that the Rule only applies to real property interests. Five states allow very long trusts or perpetuities periods of up to 1,000 years. A dwindling number of jurisdictions, including California, still follow the Rule Against Perpetuities.

DIRECTED TRUSTS

Unlike South Dakota, where the directed trustee model is a predominant structure, California does not see the same level of utilization. The limited adoption of the directed trustee model in California may be viewed as a disadvantage, potentially restricting the flexibility and benefits offered by this trustee structure. Under present California trust law, trustees are the only fiduciaries (i.e., legally appointed representatives) with the duty, authority and power to administer a trust's assets, liabilities and financial and legal affairs. The trustee's primary duty is to carry out the terms of the trust for the benefit of the beneficiaries. Effective January 1, 2024, however, the Uniform Directed Trust Act ("UDTA") becomes law in California. The UDTA adds new sections 16600 – 16632 to the Probate Code to allow Directed Trusts to exist in California.

The UDTA allows for an additional type of fiduciary, called a Trust Director, to participate in trust administration. The Directed Trust was created in the early 1900's because wealthy families wanted to make trust investment decisions, instead of the trustee, that the trustee would perform. Under the UDTA, a trustee becomes a Directed Trustee. A Directed Trustee must carry-out the Trust Director's decisions within the scope of the Trust Director's authority. That is, "[i]n a directed trust, the terms of the trust grant a person other than a trustee a power over some aspect of the trust's administration."

California demonstrates potential limitations in the utilization and regulatory support for the directed trustee model compared to South Dakota where according to the South Dakota Department of Banking, approximately 68% of trust business conducted is through a directed trustee. Concerns may include the limited adoption of the directed trustee model, potential restrictions on family advisors, the percentage of trust business through directed trustees, the lack of explicit statutory protections, and potential oversight gaps in California's statutes. These factors contribute to a narrative critical of California's approach to directed trusts.

TRUST PROTECTORS

South Dakota took a forward-thinking step in 1997 by adopting a Trust Protector statute, maximizing flexibility for trusts across generations. California trusts and estates law does not codify the rights and duties of a trust protector. As such, a trust protector's legal role in California depends on the terms of the trust document combined with the state's legal precedents potentially restricting the adaptability and effectiveness of trusts over time. The absence of a Trust Protector statute in California may be seen as a drawback for those considering the jurisdiction for trust formation.

DECANTING

In contrast to South Dakota's flexible and highly ranked trust decanting statute, California may be criticized for potential limitations in its decanting provisions, limiting opportunities for future planning and adaptation to changing circumstances. South Dakota boasts the most flexible and highly ranked trust decanting statute in the nation, allowing for the expansion of a trust to a fully discretionary structure and enabling the inclusion/exclusion of any beneficiaries. South Dakota's trust decanting statute does not restrict the trustee from decanting into a structure that accelerates a remainder beneficiary's interest and South Dakota's flexible trust decanting provisions provide much more opportunity for future planning for estate, gift tax, and income tax purposes.

California addressed the decanting question when it enacted the Uniform Trust Decanting Act on Sept. 14. 2018. Prior to enactment, a court proceeding or the consent of all trust beneficiaries was necessary to modify the provisions of a California irrevocable trust, absent trust language providing otherwise. Under the new law, subject to certain exceptions, a trustee may modify an existing irrevocable trust without the consent of the settlor and beneficiaries, or prior court approval, by pouring the assets from the old trust into a new, enhanced trust.

However, only certain trusts may be decanted. For example, a trust held solely for charitable purposes, such as a private foundation structured as a trust, cannot be decanted. A trust containing a charitable interest, such as a trust with a charity as a remainder beneficiary, can be decanted, however.

The more discretion the trustee has over the principal distributions, the more options the trustee has for modifying the trust through decanting. The provisions regarding what can be modified through decanting break down into two categories: (1) the rules that apply to trustees with "limited distributive discretion" and (2) the rules that apply to trustees with "expanded distributive discretion."

The new statute defines a trustee with limited distributive discretion as a trustee that has discretion to distribute trust principal that is limited to an ascertainable standard. For example, a trust may provide a trustee with the power to distribute principal for the beneficiary's health, education, maintenance or support. (This is also known as a HEMS standard or reasonable support standard.) A trustee with limited distributive discretion may exercise the decanting power to modify administrative provisions of the trust, including the successor trustee provisions or the powers of the trustee. However, the trustee may not materially change the dispositive provisions of the trust.

A trustee with expanded distributive discretion is defined as a trustee that has discretion to distribute trust principal that is not limited to an ascertainable standard or reasonable support standard. For example, a trust may give the trustee sole discretion to make distributions of principal. A trustee with expanded distributive discretion may exercise the decanting power to modify both the administrative provisions and certain dispositive provisions of the trust. The trustee could use the decanting power to eliminate a beneficiary, change the standard for distributions, grant a power of appointment or extend the duration of the trust. Generally speaking, however, a trustee may not add a new beneficiary (except perhaps indirectly by granting a power of appointment to a beneficiary).

Even if a trustee has expanded distributive discretion, significant limitations restrict its ability to modify trust provisions related to trustee compensation, trustee liability, and the removal or replacement of a trustee.

Likewise, substantial limitations exist regarding the modification of trust provisions related to charitable interests. For example, if a trust contains a charitable interest — such as having a charity named as an ultimate remainder beneficiary — and all family members are deceased, the new trust created through the decanting cannot diminish the charitable interest.

Some of the most stringent limitations on decanting are the rules related to tax benefits. Under the Act, the decanting power cannot be exercised in any way that would jeopardize the tax benefits of the original trust. The Act contains savings language to avoid inadvertent negative tax consequences from the changes. It also makes clear that, subject to certain protections, a trustee may exercise the decanting power to change a trust from a grantor trust to a nongrantor trust or vice versa.

Before exercising the decanting power, a trustee must give at least 60 days' notice to (1) the settlor, (2) each qualified beneficiary, (3) each holder of a presently exercisable power of appointment over the original trust, (4) each person with a current right to remove or replace the trustee, (5) each other trustee of the original trust, (6) each trustee of the new trust and (7) the California Attorney General, if the original trust contains certain charitable interests. The act provides guidelines on what must be stated in the notice, including specific warning language notifying the recipients of their right to contest the decanting. In fact, California's newly adopted decanting statute contains stricter notice provisions than does the general Uniform Trust Decanting Act, including detailed provisions applicable to certain trusts for minors.

Although the Act may be an improvement over prior California law, it has several shortcomings including the fact that trustees with limited distributive discretion can modify only administrative provisions which significantly limits the changes that can be made to most irrevocable trusts and the strict notice provisions may require court intervention in certain decanting situations.

California's trust decanting provisions demonstrate the need for more flexibility, fewer restrictions on discretionary trusts, fewer limitations on altering income interests, fewer constraints on accelerating remainder beneficiary's interest, and an overall reduced opportunity for future planning. These factors contribute to a narrative critical of California's approach to trust decanting in comparison to states like South Dakota.

STATE INCOME TAX

When examining state income and capital gains rates in California, several critical points may be highlighted, drawing attention to potential drawbacks compared to South Dakota.

California is known for having relatively high state income tax rates, both for individuals and corporations. This can significantly impact the after-tax income of individuals and entities, making it less favorable compared to states like South Dakota, which has had no state income taxes since 1942.

California, in particular, is second only to Hawaii in having the most tiered income tax brackets, and the rate starts at 1% and climbs all the way up to the country's highest tax rate, 14.4%, and any earning over $1 million would be subject to an additional 1% "millionaire tax" that raises money for the state's mental health services. The graduated tax system and millionaire's tax ensure that the highest-income households in California pay the largest share. In 2019, the top 1% of earners paid nearly 45% of all personal income taxes.

CAPITAL GAINS

Unlike South Dakota, which does not impose state taxes on capital gains, California has state-level capital gains taxes. California capital gains tax rates are similar to the California income tax rates. A single filer can expect to pay 13.3% on capital gains of $1,000,000 or more, while a married couple filing jointly can expect to pay 13.3% on capital gains of $1,354,550 or more.

In addition, California's fiscal policies and legislative landscape may pose a risk of potential tax increases. Unlike South Dakota, where new taxes or tax increases require specific voter approval or a two-thirds majority in both legislative branches, California's tax structure may be subject to changes that could impact the financial planning and stability of individuals and businesses.

In summary, California has long been subject to criticism for its high state income and capital gains tax rates, as well as the potential for tax increases. These factors, along with the state's reliance on certain revenue sources, contribute to a narrative critical of California's tax environment compared to states like South Dakota

ASSET PROTECTION AND SPENDTHRIFT PROVISIONS

While South Dakota has clear legal precedents supporting spendthrift provisions and creditor protection, California may be seen as having potential ambiguities or gaps in its legal framework. The absence of similarly recognized and favorable case law may raise concerns about the level of protection offered to trusts and their beneficiaries in California.

In the case of In re Cleopatra Cameron Gift Trust, the South Dakota Supreme Court affirmed the validity of a trust's spendthrift provision, specifically prohibiting direct payments of a trust beneficiary's child support obligation to her ex-husband. This recognition by the court showcases South Dakota's favorable stance on spendthrift provisions, offering clear creditor protection. The South Dakota court effectively sided with the trustees in the Cleopatra Cameron case, highlighting the trustee's ability to cease payments to the ex-husband based on the spendthrift provision. This demonstrates the trustee's empowerment in handling creditor disputes and protecting trust assets.

California may be viewed as lacking similar legal clarity, potentially leading to increased uncertainty for trustees in creditor-related decisions. Cleopatra Cameron case is widely accepted as one of the most favorable creditor protection cases in recent history. This historical precedent underscores South Dakota's commitment to providing robust creditor protection measures in trust law. California may be criticized for lacking comparable cases that establish clear and favorable precedents for creditor protection.

EXTENDED EXPOSURE TO CREDITOR CLAIMS

Unlike South Dakota, where trusts are shielded from new claims after only two years, the California protection period requirement is double. The four year look back period has potential for significantly longer exposure to creditor claims in California and is widely perceived as a disadvantage, particularly for individuals in high-risk professions or those facing major life changes.

California offers less robust protection against creditor claims compared to South Dakota, with concerns about extended exposure periods and implications for individuals in high-risk professions. These factors contribute to a narrative critical of California's trust laws in the context of creditor protection.

SPE'S

South Dakota law explicitly permits individuals to serve in trust roles through entities like limited liability companies, offering liability protection without the need to meet formal Department of Banking regulations and requirements. South Dakota's legislative support for SPEs gives individuals more comfort in serving and taking on trust advisor roles. In contrast to South Dakota's express legislative support for Special Purpose Entities (SPEs), California does not provide similar statutory guidance, potentially leaving individuals and entities in the state with less clarity and security in the use of SPEs for trust-related purposes. In addition, the absence of such legislative support in California may deter individuals from assuming these roles through entities due to increased uncertainty and potentially exposing them to legal and regulatory challenges.

LIMITED PRIVACY

While South Dakota provides a permanent seal of privacy for trust litigation, automatically attaching and lasting in perpetuity, California's regulations do not offer the same level of protection or permanency.

While the right to privacy in California is Constitutionally protected, its protection is not absolute. The protection afforded by the right to privacy is qualified, and can be set aside after the court weighs the right to privacy against the need for discovery in a given case.

Unlike South Dakota's approach, which ensures that trust matters remain private, California's regulations allow for a greater degree of public accessibility. Trust-related proceedings and associated documents in California may be more susceptible to public inspection, potentially compromising the confidentiality that individuals and families seek when establishing trusts.

SILENT TRUSTS

Unlike South Dakota, where there are detailed provisions in the statute allowing trust settlors, trust instruments, and trust advisors (such as a trust protector) to restrict or eliminate information to trust beneficiaries and maintain trust actions quietly, California's quiet trust provisions are limited by the duration of the grantor's life or incapacity, effectively rendering the gold standard of "grantor's intent" meaningless beyond the grantor's quietus. In contrast, South Dakota allows the silence of a quiet trust to outlive the grantor, enduring even in death. California's potential limitations on the duration of quiet trust provisions may be criticized for not providing the same level of enduring confidentiality. South Dakota's emphasis on the enduring nature of quiet trusts, even after the grantor's death, underscores the state's commitment to providing a high level of confidentiality.

INSURANCE PREMIUMS

South Dakota stands out for having the lowest insurance premium tax at 8 bps (.008%) on premiums exceeding $100,000 for trusts purchasing private placement life insurance. In contrast, California's premium tax rates top out at 2.35% making it less attractive for individuals considering trusts involving significant life insurance policies.

LEGISLATIVE SUPPORT

While South Dakota annually updates its trust law statutes through the Governor's Task Force on Trust Administration Review and Reform, California has no comparable mechanism for regular updates. The absence of an annual review process may suggest a potential gap in California's responsiveness to the evolving needs of the legal and advisor community.

South Dakota's track record includes the introduction of innovative trust laws such as Community Property Trusts in 2016 and the 2016 Family Advisor provision. South Dakota's Purpose Trusts of unlimited duration, introduced in 2006/2008, allow for trusts dedicated to pets, vacation homes, or any non-charitable purpose without a beneficiary. In contrast, California may be seen as lacking a similar framework for specialized purpose trusts, potentially restricting individuals and families from creating trusts tailored to their unique needs and objectives.

South Dakota's commitment to regular updates and reforms through the Governor's Task Force suggests a proactive approach to maintaining a modern and responsive trust law framework while potential criticisms of California include emphasizing the need for more regular updates, missed opportunities for innovative trust laws, limited flexibility in trust administration teams, a lack of specialized purpose trusts, and a risk of legal stagnation. These factors contribute to a narrative critical of California's approach to trust law evolution in comparison to states like South Dakota.

STRENGTH OF STATE

On the basis of its solvency in five separate categories, South Dakota ranks 2nd among the US states for fiscal health. South Dakota has between 4.76 and 6.78 times the cash needed to cover short-term obligations, well above the US average. Revenues exceed expenses by 2 percent, with an improving net position of $106 per capita. In the long run, South Dakota has a net asset ratio of 0.34. Long-term liabilities are lower than the national average, at 8 percent of total assets, or $650 per capita. Total unfunded pension liabilities that are guaranteed to be paid are $13.32 billion, or 32 percent of state personal income.

In contrast, based on the same categories, California ranks 42nd among the US states for fiscal health. California has between 0.82 and 1.62 times the cash needed to cover short-term obligations, well below the US average. Revenues exceed expenses by 4 percent, with an improving net position of $271 per capita. In the long run, California's negative net asset ratio of 0.57 points to the use of debt and large unfunded obligations. Long-term liabilities are higher than the national average, at 92 percent of total assets, or $5,642 per capita. Total unfunded pension liabilities that are guaranteed to be paid are $1,190.84 billion, or 54 percent of state personal income. OPEB are $106.06 billion, or 5 percent of state personal income.

CONCLUSION

In the intricate tapestry of trust and estate planning, the selection of a trust situs is a decision of paramount importance, with far-reaching implications for the preservation and perpetuation of wealth. Throughout this white paper, we have meticulously examined the advantages that distinguish South Dakota as an unparalleled trust jurisdiction. In closing, it becomes evident that when juxtaposed with the complexities and limitations inherent in California's trust landscape, South Dakota emerges as the unequivocal choice for those seeking an optimal environment for wealth management and succession planning.

California, with its vibrant economy and cultural allure, may be an attractive locale for many endeavors, but as a trust situs, it presents inherent challenges that diminish its viability in comparison to South Dakota. Perhaps most notably, California imposes a state income tax, which can erode the long-term growth and preservation of trust assets. In contrast, South Dakota's absence of state income tax stands as a beacon for those desiring a tax-efficient environment to nurture and protect their wealth.

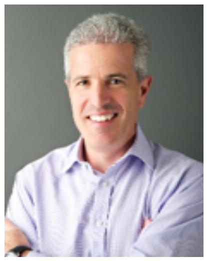
Moreover, California's adherence to the Rule Against Perpetuities and its limitations on the duration of trusts stand in stark contrast to South Dakota's progressive stance on perpetuities, allowing for trusts to endure indefinitely. This critical difference affords families and individuals utilizing South Dakota as their trust situs the flexibility to implement enduring, multi-generational wealth transfer strategies, unencumbered by arbitrary time constraints.

Asset protection, a cornerstone of trust planning, further underscores the divergence between these two jurisdictions. South Dakota's robust legal framework provides enhanced asset protection mechanisms, offering a secure fortress against potential creditors and legal challenges. California, while providing certain safeguards, lacks the comprehensive protection afforded by South Dakota's legislation, potentially leaving trust assets exposed to a more unpredictable legal landscape.

In the realm of trust-friendly legal environments, South Dakota's commitment to privacy is also a compelling factor. The state's policies safeguard the confidentiality of trusts, providing a discreet environment for families to manage their affairs without unnecessary public scrutiny. This stands in contrast to California, where greater transparency requirements may compromise the privacy and confidentiality of trust arrangements.

In conclusion, the advantages that distinguish South Dakota as a preeminent trust situs—ranging from tax efficiency and perpetual trust duration to robust asset protection and privacy—underscore its superiority over California in the realm of trust and estate planning. As individuals and families navigate the complexities of wealth preservation, the choice of trust situs should be a strategic one, and South Dakota emerges as the pinnacle, offering an environment conducive to the creation of enduring financial legacies.

About the authors



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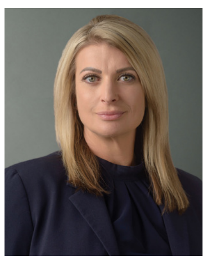

As an attorney, Nicole Byrum brings a unique perspective to her position as Chief Fiduciary Officer – partnering with her clients and their advisors to craft strategic trust vehicles which provide asset protection, governance and long-term wealth transfer. After a brief stint practicing law, she transitioned into global trust services before joining the Sterling team at our Sioux Falls, SD, headquarters. Nicole earned a JD from the University of South Dakota School of Law and a BA from the University of Washington. She also earned the Certified Trust and Financial Advisor (CTFA) designation from the ABA.

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