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Trusts 101: South Dakota puts the *special* in Special Purpose Entity

South Dakota is consistently regarded by high-net-worth individuals and their trusted advisors as the premier trust situs for multigenerational wealth planning. No state income tax, no rule against perpetuities, ultra-modern decanting and modification statutes, virtual representation, community property trusts, asset protection, and best in the nation privacy statutes are all benefits that make South Dakota trust situs second to none. A lesser known yet equally substantial advantage to a trust situated in South Dakota is the ability to leverage South Dakota's special purpose entity statute.

A special purpose entity ("SPE") is a South Dakota LLC or corporation established for the exclusive purpose of directing the administrative trustee of a South Dakota situated trust. The SPE houses the trustpowerholders as its board of managers, creating a layer of separation between the individuals acting as powerholders, and the decisions made in their respective capacities. Decisions related to distributions, investments, and trust protector functions are made at the LLC level by the SPE, not the individual powerholder.

South Dakota was the first state in the nation to enact special purpose entity legislation and remains one of a small handful of jurisdictions that have SPE statutes on the books.

History

South Dakota's directed trust statutes are based on the premise of separating fiduciary trust powers ([SDCL 55-1B](#)). The trust protector, investment trust advisor, distribution trust advisor, or any combination thereof, are responsible for directing the administrative trustee. Because these appointments are critically important, a grantor may nominate individuals who are personally known to him/her, trusted colleagues, personal advisors or even family members. However, the decision making delegated to these individuals may bring with it unwanted risk and potential liability. Power holder decisions may be challenged by future beneficiary's or other parties to the trust. The potential for litigation can be daunting and insuring against the risk to these individuals is almost impossible as D&O and E&O coverage is rarely available to individuals.

Mitigating individual liability can be accomplished by forming a special purpose entity in tandem with a South Dakota directed trust. An SPE is organized as a South Dakota LLC or corporation that is established for the exclusive purpose of directing the administrative trustee as to the trust investments, distributions, and trust protector functions, insulating the powerholders from personal financial risk related to the decisions made in their respective fiduciary capacities.

Under South Dakota law, SPE's are granted special status, so not only is the SPE able to act as fiduciary and exercise fiduciary powers, but it is also classified as an unregulated entity and is thereby excluded from the South Dakota Division of Banking's regulatory requirements under [SDCL 51-A-5-6](#) and [51A-6A](#).

Architecture

The specific elements that qualify a South Dakota SPE for special designation as an unregulated entity are articulated in [SDCL 51A-6A-66](#). As noted previously, the SPE must be created for the specific purpose of acting as the trust protector, investment advisor, and/or distribution advisor, exclusive to all other purposes.

The trustee must be a South Dakota trust company, South Dakota bank with trust powers, or a national bank with trust powers. Conversely, the SPE itself is prohibited from engaging in trust business and cannot hold itself out as a trust company or fiduciary.

The SPE is also required to file an annual financial report agreeing to be subject to exam by the South Dakota Division of Banking at the agency's discretion. Further, the trust instrument must designate the SPE by name, and that entity name cannot contain the word "trust."

As a practical matter, the SPE's formation documents should include a recital of its exclusive purpose, the board of members and their respective duties, as well as a member succession plan.

Collateral Benefits

In addition to limiting potential liability for individuals serving in trust advisory capacities, SPE's can also provide continuity for the trust when faced with succession issues arising out of vacancy, resignation, disability, or death of individuals serving as advisors.

Many trusts are designed to endure through multiple generations, or even exist in perpetuity. Inevitably, most trusts will outlive appointed advisors, however, there is no need for disruption to trust administration; delayed distributions or foregoing time sensitive investment decisions. Creating an SPE can give the settlor and their family the piece-of-mind that only a well drafted succession plan can provide.

Within the formation documents of the special purpose entity, the springing advisors can be identified well in advance and be ready to act immediately. The SPE can exist in perpetuity and include provisions addressing trust advisor and trust protector succession for future generations, particularly beneficial when considering a dynasty trust structure.


South Dakota SPE's also serve to establish a substantial presence in the state for situs purposes. The SPE, a South Dakota entity, firmly establishes a nexus to South Dakota and all but eliminates the potential for situs challenge. This is particularly beneficial when individuals serving in advisory capacities reside in other, higher tax jurisdictions.

Conclusion

The multitude of benefits and low cost of creation make the South Dakota special purpose entity a valuable tool for multigenerational wealth-planners and family advisors. HNW client's residing in less favorable trust jurisdictions can create South Dakota trust structures that provide their assets with the most effective framework in which to grow.

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