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South Dakota's Special Spousal Property Trust

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South Dakota's Special Spousal Property Trust: Community Property by Designation

Synopsis

Enhancing its status as a premier trust jurisdiction, South Dakota recently enacted legislation authorizing married couples to form a trust and achieve a 100% stepped up cost basis on trust assets specifically designated as community property. South Dakota joins Alaska and Tennessee as the only states specifically authorizing such trusts.ⁱ

These trusts have become popularly known as the Community Property Trust. In an effort to distinguish South Dakota's version of the trust, South Dakota legislation refers to its trust as the Special Spousal Property Trust ("SSPT").ⁱⁱ Assets owned by a SSPT can be designated as community property under IRC Section 1014(b)(6) for tax purposes.ⁱⁱⁱ The ability to designate assets as community property and achieve the resulting stepped up cost basis associated with community property is indeed special. This summary briefly discusses the background of the SSPT, creating a SSPT, its planning applications and, finally, the risks associated with using a SSPT.

Background

How the laws of each state treat marital property fall into 2 general categories: community property states and common law property states. Married couples who reside in a community property state have the tax advantage of receiving a 100% stepped up cost basis on community property upon the first spouse's passing.^{iv} That's a powerful advantage. There are only nine community property states. South Dakota is not one of them; neither is Alaska or Tennessee. South Dakota is a common law state. Married couples who reside in a common law state and own property jointly will receive a stepped up cost basis on only 50% of the jointly owned assets.^v

South Dakota's newly enacted SSPT legislation offers married couples the option to benefit from the powerful advantage of the community property designation. The South Dakota law authorizes a married couple to form a trust which specifically designates assets held by the trust as community property and achieve a 100% stepped up cost basis on the death of the first spouse.

Married couples need not be residents of South Dakota to form a South Dakota SSPT. Any married couple can form a SSPT in compliance with South Dakota law.

The Roadmap to the Destination of Community Property by Designation

SDCL Chapter 55-17 furnishes the road map to create a SSPT. The trust must expressly designate some or all of the trust assets as special spousal property (aka community property). The trust must contain required disclosures and consent language in the manner provided for by South Dakota law. The trust must be signed by both spouses. State law gives helpful guidance on other matters that can be addressed in a SSPT and furthers South Dakota's preference for grantor sovereignty in drafting a trust instrument. If a trust holds assets designated as

community property and also holds assets that are not community property, the trustee must observe proper record keeping in order to identify which property is designated as community property and which property is not. Another important requirement for a qualified SSPT is the appointment of a qualified South Dakota Trustee of the trust. A qualified South Dakota trustee is either a South Dakota resident, a South Dakota chartered trust company, or an entity with South Dakota trust powers.^{vi}

Planning Applications

The SSPT presents several planning applications. Initially, a significant advantage is the elimination of the guessing game on the order of death for a married couple. As a result of the 100% stepped up cost basis on the first spouse's death, planning decisions tied to speculating which spouse will die first are resolved by using a SSPT.

Any low cost basis capital assets, whether real property, marketable securities, tangible personal property or family business interests, are ideal assets to transfer to a SSPT. The SSPT can be integrated with a variety of trusts authorized under South Dakota law adding more value to such trusts. They include:

- Irrevocable Trusts
- Revocable Living Trusts
- A trust that holds both designated community property and non-community property
- Domestic Asset Protection Trusts
- Legacy, Dynasty or Perpetuities Trusts
- SD ING Trusts
- Grantor Trusts & Non-Grantor Trusts
- Spendthrift Trusts

Furthermore, couples who reside in community property states can now form a SSPT under South Dakota's advantageous trust laws and fund it with community property without giving up the advantages of the original community property designation by incorporating the SSPT rules in their new South Dakota trust. It is also possible to modify, reform, or decant an existing trust to incorporate the SSPT language and attain community property status on designated trust assets.

South Dakota law promotes flexibility in drafting a SSPT. The terms of a SSPT can define the rights and obligations of the beneficiaries to the trust property, management rights of the

property, disposition of the assets on the termination of the trust, how the trust can be amended and any other matter as long as it does not violate public policy or a statute imposing a criminal penalty.^{vii} However, a SSPT cannot affect child support obligations or certain creditor rights, and the SSPT cannot affect the duty of good faith between the spouses.^{viii} Assets designated as special spousal property, or community property, will lose separate property status in the event of divorce.

Risk Considerations

As with other tax planning strategies, the risk of IRS challenge is present with the SSPT. The IRS has not commented or ruled on the SSPT or Community Property Trust technique as a means of achieving a 100% stepped up cost basis on the first spouse's death. The IRS has recognized that state law defines what property is and the characteristics of marital property. This principle, coupled with the fundamental concept that states are laboratories of democracy,^{ix} suggest strongly that the IRS will not find offense with the SSPT strategy.

The Community Property Trust concept has been codified in other states since 1998 when Alaska first enacted its statutory regime authorizing designated community property. Tennessee passed its Community Property Trust statute in 2010. The IRS has not challenged trusts formed under either state's law in any reported decision or ruling.

Even though results cannot be guaranteed, it appears the downside of a successful IRS challenge is that only one-half of the assets in a SSPT would receive a stepped up cost basis on the first spouse's passing, as is the current rule for jointly owned property in a common law state. Except for the transaction cost of establishing the SSPT and defending a challenge, it appears the couple would be no worse off than if they did nothing in the event of a successful IRS challenge.

Community property by designation merits close consideration by couples with low cost basis assets. Careful consideration should be given to the risks of the strategy and the terms of the SSPT. Only after a couple is satisfied they have made an informed decision should the SSPT strategy be employed.

ⁱ Neither Delaware nor Nevada authorizes SSPTs or community property trusts.

ⁱⁱ SDCL Ch. 55-17

ⁱⁱⁱ SDCL § 55-17-5

^{iv} IRC Section 1014(b)(6)

^v IRC Section 1014(a)

^{vi} SDCL §§ 55-17-1, 55-3-41, and 55-3-39

^{vii} SDCL § 55-17-9

^{viii} SDCL §§ 55-17-10 and 55-17-11

^{ix} Supreme Court Justice Louis Brandeis, *New State Ice Co. v. Liebmann*, 285 US 262 (US 1932)