

Law Offices of
Thomas J Bouman PLLC

ESTATE PLANNING • INHERITANCE PROTECTION

7650 E. BROADWAY BLVD. #108
TUCSON, AZ 85710

PHONE (520) 546-3558
TOM@TOMBOUMANLAW.COM

Affordable Asset Protection Strategies for Arizona Residents

My first exposure to asset protection planning occurred during law school while working part-time for an estate planning attorney in 1998. The attorney taught me a sophisticated legal strategy that many of his clients were using to shield assets from future or unknown creditors. I worked behind the scenes to help set up several estate plans that incorporated the attorney's strategy. After graduating from law school, I joined a law firm with expertise in a wide range of asset protection strategies including irrevocable trusts, limited liability partnerships, and foreign variable life insurance policies. Our firm counseled many clients to implement these legal strategies in order to protect assets from future threats and discourage frivolous lawsuits.¹

Five years later I established my own estate planning law firm and began to incorporate asset protection strategies into my own clients' estate plans. Since then, however, I have observed that while most clients are eager to include asset protection techniques for their beneficiaries (after death), many of them resist any proposed strategies to protect their own assets during lifetime. The reasons are simple, but unfortunately, difficult to overcome:

1. Too complicated to understand
2. Too expensive to implement

However, many asset protection strategies are codified by statute and available free to any Arizona resident. In fact, there are a handful of simple methods for almost anyone to protect assets from future or unknown creditors. Here are four examples:

1. Use of statutory exemptions prescribed by Arizona law, which automatically protect specific assets from seizure, even in the event of personal bankruptcy.
2. Purchase of life insurance policies and annuities, which include an investment component protected from seizure by Arizona law.²
3. Investment in tax-deferred retirement accounts, which are protected from seizure by federal and/or Arizona law.

¹ The asset protection techniques described in this article will not protect assets from existing or known creditors, or from a potential creditor when a lawsuit or claim is imminent (*see* Uniform Fraudulent Transfer Act). I will not represent anyone who expresses intent to hinder, delay or defraud any known or reasonably foreseeable creditor. Asset protection planning is intended solely for responsible individuals who wish to proactively shield assets from future threats, and not as a responsive measure to a clear and present danger. Clients must be willing to sign an affidavit evidencing intent to remain financially solvent after any transfer and to refrain from fraudulent transfers.

² Term life insurance policies do not include an investment component so there is no asset to protect during the insured's lifetime.

4. Use of the Arizona homestead exemption, which protects up to \$150,000 of equity in a personal residence.

But these methods do not work for everyone.

Many people I speak with would benefit from more sophisticated asset protection strategies, the type generally believed to be too complicated and too expensive. I am not referring to families with vast inherited wealth or the Mark Zuckerberg-type entrepreneurs. They are already motivated to implement the very best asset protection strategies and can afford to do so.

I am most likely thinking about you. Do you sometimes worry that a lawsuit against you could wipe you out financially? Have you built up a life savings that, although it may not make you rich and famous, you know is large enough to make you a target for lawsuits?

I want to help you.

This article describes two strategies that you can implement right now. You can implement either strategy by itself or combine them. Both strategies are proven to work, although they are not overly exotic, nor are they very difficult to administer.

Each strategy has two approaches to choose from – one a little stronger and more sophisticated than the other.

None of the strategies is bullet-proof, but of course, no asset protection strategy ever was or will be. You will, however, make it measurably more difficult for future or unknown creditors to seize your personal assets.

So how do you know if one of these strategies might be for you? Consider these examples:

- You own financial investments (savings, brokerage accounts, notes receivable, etc.) not in a retirement account with a combined value of more than about \$250,000.
- You own a personal residence with more than \$150,000 in equity.
- You own investment real estate (other than your personal residence) with any amount of equity, even if it is currently held by a limited liability company.
- You own a small business that would likely survive your death or retirement.

Strategy #1 – Family Limited Liability Company

The first strategy is the family limited liability company (“LLC”). This is a form of business or investment entity ownership, which seeks to provide its owners (“members”) with enhanced protection from creditors and, until recently, substantial estate and gift tax savings.

An active business is not required;³ rather any person may transfer personal investments to a LLC and qualify to receive the same asset protection benefits as a business owner would. A *family* LLC is established just like a regular LLC except that participation is limited to persons related to each other by blood or marriage.

Typically a family LLC would own rental properties, brokerage accounts, and all or a portion of the family business; however, a LLC may own almost anything. An exception is a personal

³ A valid business purpose is required; however, the LLC need not be actively selling a product or service to the general public.

residence. The irrevocable spendthrift trust (Strategy #2) is a better option for protecting the equity in your personal residence.

The assets you contribute to a LLC benefit from charging order protection. This means that a judgment creditor can obtain a court order that redirects any distributions from you to the creditor. But the manager of the LLC (most likely you) need not pay out any distributions, which puts you in a much better negotiating position for a settlement. This level of protection is available to anyone creating a LLC using forms provided by the Arizona Corporation Commission. I refer to this self-help version as a “starter LLC” in this article.

The protection provided by a starter LLC is better explained with an example. Imagine you manage a rental property, which is titled in the name of a starter LLC. If a tenant is severely burned by a malfunctioning water heater and your homeowner insurance fails to cover the claim, then the tenant would likely try to win a court judgment and collect payment from you. As long as you have complied with applicable laws, refrained from comingling company and personal assets, and did not personally cause or know about the malfunctioning water heater, the tenant’s only remedy should be to obtain a charging order against the LLC. Your rental property and other personal assets will be safe from seizure when the tenant attempts to collect on the judgment.⁴ Thus, a starter LLC can isolate company liability from personal liability.

Now imagine another scenario where you are at fault in a car accident while traveling on vacation. Could the other driver seize your rental property from the LLC in order to satisfy a judgment against you?⁵ The answer is MAYBE (and in many states, YES). This is where a starter LLC may fail you and professional counsel from an attorney becomes most valuable. If the LLC is structured properly and its members hold their interests subject to a highly restrictive operating agreement, you will be in a much better negotiating position for an out-of-court settlement.

If your LLC includes a “one-size-fits-all” operating agreement, or worse yet does not have one, your plan to protect the rental property and its income stream from seizure is a risky proposition. A LLC optimized for asset protection must include an operating agreement that carefully defines and restricts the ownership and transfer rights of its members. These restrictions act as the fortress wall to keep creditors in both scenarios from burning down your possessions inside. They discourage a creditor from even attempting to obtain a charging order or to otherwise interfere with your LLC activities. A starter LLC basically invites a potential creditor to obtain a charging order and wait expectantly for distributions. A restrictive operating agreement shields LLC assets by making any involvement with your LLC unattractive to a potential creditor.

You might wonder what types of restrictions I am talking about. One example is that members are prohibited from withdrawing from the company and reacquiring contributions, which could then be seized by a creditor. Another example is that members have no right to participate in management or vote out managers. More examples include prohibitions on members seeking a partition of company assets or dissolving the company without unanimous consent of all members and managers. The result is to limit a creditor’s ability to interfere with LLC activities if a charging order is obtained and make an out-of-court settlement more appealing.

The structure of a LLC may be strengthened over time by gifting or selling membership interests to additional family members either outright or in trust. A multi-member LLC is generally stronger

⁴ This is referred to as an inside liability because the claim was directly related to the LLC.

⁵ This is referred to as an outside liability because the claim was the result of events unrelated to any LLC activities or assets.

than a single-member LLC, especially in personal bankruptcy. For example, Mom and Dad might gift 10% of their membership interests in equal shares to irrevocable trusts for their two children. Mom and Dad may continue to manage and control all 100% as managers of the LLC and trustees of the irrevocable trusts.

The LLC must be registered in a state with protective LLC laws. The most protective state laws (including Arizona) provide that a charging order is the only remedy a court can use to seize assets from a LLC. A few states go even further to limit the rights of creditors against a LLC registered in those states. For example, the state of Wyoming blocks creditor access to books and records of the LLC and does not require disclosure of managers or members in the Articles of Organization.⁶ More importantly perhaps, Wyoming also provides statutory protection for single member LLCs – something Arizona law does not. This makes the Wyoming LLC a particularly good choice for ownership of S-Corp stock.⁷

Strategy #2 – Irrevocable Spendthrift Trust

The second strategy is the irrevocable spendthrift trust. In its simplest form, a person (the “trustor”) re-titles ownership of an asset into the name of an irrevocable trust, which is managed by another person or company (the “trustee”). The assets you contribute to a spendthrift trust are protected from your future or unknown creditors.⁸ The catch is that you may not serve as trustee of the trust. The trustee may be a spouse, child, or friend; although an independent person or entity, like a bank, is recommended. You may, however, retain the right to fire and replace the trustee you named initially.

You may use the irrevocable trust as an alternative to the LLC (by transferring your investments directly to the trust) or combine the two strategies by transferring your LLC membership interests to the trust. By combining the strategies, you can protect assets from seizure (with the LLC charging order protection) and the income they produce (distributions are protected by the spendthrift trust). You may also continue to personally manage the LLC assets, even though you are not a trustee of the trust that owns your membership interests.

Although transfers into a spendthrift trust are irrevocable, the trust is usually drafted so any income tax continues to be paid by the trustor (you) and not by the trust itself. Thus, a personal residence may be transferred to an irrevocable trust without losing the ability to exclude gain upon sale (up to \$250,000 per person) or the step-up in income tax basis upon death.⁹

There are two approaches when structuring a spendthrift trust for an Arizona resident.

Option 1 is to establish the trust using Arizona law.¹⁰ You may name anyone (except yourself) as trustee, although you may not name yourself as a beneficiary of the trust. But if a judgment is obtained against you, the trustee may distribute assets to the beneficiaries you named in the trust document.

⁶ This type of business entity is called a “Wyoming Close LLC.”

⁷ A multi-member LLC does not qualify as an S Corporation shareholder.

⁸ There are exceptions to this general rule. For example, many states refuse to shield the trust assets from child support claims. Also, the strategy is not likely to work if you transfer *all* of your personal assets to the trust. You must remain solvent on your personal net worth statement, even after contributing assets to the spendthrift trust.

⁹ This is referred to by accountants as grantor trust status.

¹⁰ The Arizona spendthrift trust includes a “flight” provision permitting an independent trust protector to move the trust to another state – like Wyoming – at a later date if appropriate.

Option 2 is to establish the trust using the law of a state that permits self-settled asset protection trusts, i.e., the type where you may name yourself as a beneficiary of the trust. Arizona does not permit self-settled asset protection trusts, but Wyoming does.¹¹ In order to establish the trust in Wyoming, you will need to retain a Wyoming individual or entity as trustee and maintain an “umbrella” insurance policy of at least \$1 million. The initial and annual costs are higher, but the benefit is that your trustee may make distributions directly to you.

How Much Does This Cost?

Asset protection planning is a highly specialized area of law that commands very high legal fees. Many lawyers will charge tens of thousands of dollars for this type of work. But my objective here is to offer two strategies that many people would benefit from at an affordable price.

To see current prices and cost estimates, visit my website.

I keep my legal fees affordable by systematizing the set-up process wherever possible. However, this works to your advantage because you will implement a strategy that has worked consistently for others before you. I also refrain from using exotic or unusual strategies that are new or particularly aggressive. This is not an area of law where you should want to break new ground.

About the Author

Thomas J. Bouman provides legal counsel in the areas of estate planning, estate settlement, and asset protection. He brings a highly systematic approach to the practice of law, which is critically important when wading through the complex, and often bizarre, legal requirements associated with estate and trust law. Mr. Bouman is author of the Arizona Estate Administration Answer Book and a prominent member of Wealth Counsel, LLC, the nation’s premiere organization of estate planning attorneys.

¹¹ Self-settled trusts are permitted in a handful of states, including Wyoming, Delaware, Alaska, and Nevada.