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

Lifetime Asset Protection Strategies for Arizona Residents

Asset protection planning has now become a regular component of comprehensive estate plans in the United States.[1] Most Americans with any significant accumulated wealth recognize the danger of leaving inheritance outright to a beneficiary, even when the beneficiary is a responsible adult. Assets left directly to a beneficiary are exposed to the beneficiary's judgment creditors during litigation, ex-spouses upon divorce, and financial creditors when filing for bankruptcy. It is relatively simple to integrate an effective trust-based strategy into an estate plan in order protect inheritance against these future threats.

But I have observed that while most people are eager to include inheritance protection trusts in their estate plans, many of these same people resist strategies to protect their own assets during lifetime. The typical reasons are:

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

<u>But these methods do not work for everyone</u>.

[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 Voidable Transfers 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.

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 complex asset protection strategies and can afford to do so.

I am most likely thinking about you. Do you sometimes worry that an unexpected lawsuit 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.

Neither strategy 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 – Asset Protection Trust

The first strategy is the asset protection trust. Procedurally, an asset protection trust may be established when a "trustor" transfers ownership of an asset into an irrevocable trust, which is managed by a "trustee" for benefit of one or more "beneficiaries". The assets you contribute to an irrevocable trust are generally protected from your future or unknown creditors.[3] The catch is that you cannot name yourself as both trustee and beneficiary like you would normally in a revocable living trust for probate avoidance. In other words, you cannot "self-settle" your own irrevocable asset protection trust and retain the power to make distributions back to yourself. This arrangement does not provide any asset protection and is against public policy in all 50 states.

Some states like Wyoming and Nevada[4] do permit self-settled asset protection trusts using a third party trustee, which means you may remain a beneficiary of the trust and protect the trust assets from your future or unknown creditors. Although Arizona law does not permit self-settled asset protection trusts, there are two hybrid approaches to consider, both effective in Arizona:

[3] 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.
[4] Approximately 16 states permit some self-settled asset protection trusts in some variation. The most well-known are Alaska, Nevada, Wyoming, South Dakota, and Delaware.

Option #1- Trustor's Children are Lifetime Beneficiaries

In Option #1 you would name one or more children (or other non-spouse beneficiaries) as lifetime beneficiaries, excluding yourself or your spouse. The advantage is that you may serve as trustee and maintain control of the assets in the irrevocable trust. The trust may be established as an individual trust or a joint trust established by a married couple. Although your children would have a right to information about the trust, you retain discretion whether to make any distributions to them during your lifetime. The trust assets will be protected from your creditors during your lifetime – because a trustee is not permitted to make distributions to you – and from creditors of your children both during and after your lifetime.

Option #2- Trustor's Spouse is a Lifetime Beneficiary

In Option #2 you would add your spouse as a lifetime beneficiary, and if desired, name your spouse as trustee. Similar to Option #1 the trust assets will be protected from your creditors during your lifetime and from creditors of your spouse and children both during and after your lifetime. The difference is that your spouse is an eligible beneficiary even during your lifetime, so in theory, your spouse can withdraw funds if there is a legitimate need. The trust must be established as an individual trust with any contributions coming from your separate property or your one-half of community property.

If neither option sounds appealing because you must exclude yourself as a beneficiary, then you might consider a third approach that relies on the laws of another state:

Option #3- Trustor is a Lifetime Beneficiary

In Option #3 you would establish the trust in a state that permits self-settled asset protection trusts, such as Wyoming or Nevada, in order to add yourself as a lifetime beneficiary. Although you would not be permitted to serve as trustee, you may name an independent trustee located in that state and reserve the power to remove and replace the trustee with a new independent trustee. This is the most complicated trust for an Arizona resident to establish because it requires an out-of-state trustee and there are often other requirements like buying a liability insurance policy. But the benefit is that your trustee may make distributions from the trust directly to you.

If you choose Option #1 or Option #2, your trust may be drafted to give an independent person called a trust protector the power to move the trust to a state that permits self-settled asset protection trusts. <u>This optional "flight" provision might give you enough comfort to establish the trust using a simpler Arizona-based hybrid approach because you know a trust protector could add you as a beneficiary later if appropriate</u>.

The next planning issue is to choose whether you want the trust optimized for income tax avoidance or estate tax avoidance. If your net worth is not high enough to trigger an estate tax upon your death[5], you may wish to design your trust to be included in your taxable estate. The advantage is that trust assets will receive a full step-up in income tax basis upon death. Your beneficiaries will be able to liquidate investments with little or no capital gains tax to pay. Income

[5] As of 2017 the federal estate tax law exempts up to $5,490,000.

tax optimization is usually achieved by permitting you to redirect or reallocate the trust assets upon your death to different beneficiaries than you initially named in the trust document.

But if you want to exclude the trust from your taxable estate, then you would relinquish any rights you might have to redirect or reallocate the trust assets upon your death. And although technically permitted in some cases, the safer approach is to exclude yourself as an eligible trustee. However, your spouse would be permitted to serve as trustee under Option #2.

Strategy #2 – Family Limited Liability Company

The second 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, when supported by qualified appraisals, substantial estate and gift tax savings.

An active business is not required;[6] 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 residence. The asset protection trust (Strategy #1) 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.[7] Thus, even 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?[8] 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. <u>If the LLC is</u>

[6] A valid business purpose is required; however, the LLC need not be actively selling a product or service to the general public.
[7] This is referred to as an inside liability because the claim was directly related to the LLC.
[8] This is referred to as an outside liability because the claim was the result of events unrelated to any LLC activities or assets.

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 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 is strengthened by gifting or selling membership interests to additional family members either outright or in trust. A multi-member LLC is generally stronger 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.[9] 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.[10]

You might also consider combining the LLC with an asset protection trust, which allows you to retain day-to-day control of the LLC assets (as manager), while also permitting distributions to the beneficiaries named in your trust even if there is a judgment against you.

[9] This type of business entity is called a "Wyoming Close LLC."
[10] A multi-member LLC does not qualify as an S Corporation shareholder.

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.

Asset Protection Trusts

Issue 1- Structure

A	**Trustor's children are lifetime beneficiaries** May use individual or joint trust, but neither spouse may be a lifetime beneficiary	Trustor may serve as trustee Trustor spouse may serve as trustee Simplest to set up
B	**Trustor's spouse is a lifetime beneficiary** Individual trust required (contributions must come from separate property or trustor's one-half of community property)	Beneficiary spouse may serve as trustee Trustor spouse may serve as trustee, but safer not to More complicated to set up
C	**Trustor is a lifetime beneficiary** May use individual or joint trust Must establish trust in a state permitting self-settled asset protection trusts	Must use out-of-state trustee Trustor spouse is disqualified as trustee Most complicated to set up

Issue 2- Tax Optimization

		Advantages	Disadvantages
A	**Optimized for avoiding income taxes** Adds testamentary limited power of appointment Either spouse may serve as trustee if not otherwise disqualified.	Trust assets will get full step-up in income tax basis upon death, which minimizes capital gains tax upon sale Gives trustor the power to redirect inheritance upon death	Trust assets will be included in trustor's taxable estate, which will trigger tax if taxable estate exceeds exempt amount (currently $5.49 million)
B	**Optimized for avoiding estate taxes** Either spouse may serve as trustee if not otherwise disqualified; but not recommended for a trustor spouse	Trust assets avoid estate tax upon death of trustor	No step-up in income tax basis upon death Must be willing to lock in beneficiaries when trust is created