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Asset Protection Planning for Arizona Residents

1. What is Asset Protection Planning?

Asset protection planning is the process of using legal strategies to shield personal and business assets from frivolous lawsuits and predatory creditors. It is intended for responsible individuals who wish to proactively shield assets from future threats, and not as a responsive measure to a clear and present danger.

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 assets exposed to unnecessary legal risks, even when liability insurance is secured.

2. Are any assets protected automatically by law?

Yes. Arizona residents qualify for many asset protection exemptions, which are codified by statute and protect certain assets automatically. Here are three examples:

1. The first $150,000 of equity in a personal residence.
2. The investment component of life insurance policies and annuity contracts.[2]
3. Assets held in a tax-deferred retirement account, such as 401k and IRA.

But these exemptions do not work for everyone.

Most people I meet own brokerage account investments not held in a tax-deferred retirement account. These investments are exposed to creditors. Others own investment real estate and small businesses, which are also at risk.

[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. 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.

3. What about using liability insurance to mitigate the risk?

Liability insurance is an excellent way to mitigate the risk, however, your insurance company may use exclusions in your policy to deny coverage precisely when you need it. Also, you may be sued for an amount higher than your coverage limits.

I always recommend purchasing a reasonable amount of liability insurance, including an umbrella-type personal liability policy. The insurance coverage should at least pay for a legal team to defend your case.

4. Should I establish a Limited Liability Company to protect my assets?

A limited liability company (LLC) is highly recommended for ownership of small businesses and investment real estate. An LLC is very simple to register in Arizona and does not require an annual fee or annual report. The primary benefit of assigning your ownership to an Arizona LLC is that it isolates the risk between your LLC and your other assets. For example, if a tenant is injured at your rental property *and you were not personally at fault*, the tenant may sue the LLC as owner, but not you personally. This is called inside liability and Arizona LLC laws are designed to shield you personally from the LLC's inside liabilities.

Arizona LLC laws are also designed to protect the LLC's assets from outside liabilities. For example, if you seriously injured someone in an auto accident *and you were driving for a personal reason*, the injured person may sue you personally and then attempt to collect from your LLC. However, Arizona law will only grant the injured person a charging order against the LLC, which acts like a lien. The charging order would redirect any distributions from the LLC to the injured person, but the manager of the LLC would likely suspend any distributions until a settlement is reached.

5. Will a Limited Liability Company protect my personal residence and other investments?

No, because the LLC must have a legitimate business purpose. A business purpose would include providing a service, product, or usable space to an unrelated person or company. Every small business provides a service or product, or both, to the general public, while investment real estate provides a place to live or do business.

Your personal residence does not have a business purpose and neither does your personal investment brokerage account.

Arizona residents qualify automatically for a homestead exemption, which protects up to $150,000 of equity even if a judgment creditor forces a sale of the home. For homeowners with more than $150,000 of equity, I may recommend either a major increase in homeowners liability insurance coverage or transferring the home into an irrevocable Arizona-based hybrid asset protection trust. Neither solution requires a business purpose to implement.

Other reasons you should not transfer your personal residence into a LLC are (1) loss of exclusion of taxable gain upon sale of a personal residence, (2) loss of mortgage debt interest deduction, (3) loss of homestead exemption, and (4) possible increase in property taxes.

Likewise, while some may argue that a personal investment brokerage account has a business purpose, most would not. Therefore, I would be wary of transferring a brokerage account into a LLC unless perhaps combined with other assets that do have a business purpose. The safer approach is to either increase umbrella-type liability insurance coverage or transfer the brokerage account into an irrevocable Arizona-based hybrid asset protection trust.

6. What is an Irrevocable Arizona-based Hybrid Asset Protection Trust?

Many people I meet would benefit from an irrevocable asset protection trust, a strategy generally assumed to be too complicated and too expensive. But I am not referring to families with vast inherited wealth or the Mark Zuckerberg-type entrepreneurs. So how do you know if an asset protection trust might be right for you? Consider the value of these assets you may own:

1. The amount of equity in your personal residence above $150,000;
2. The value of your financial investments (savings, brokerage accounts, notes receivable, etc.) not held in a retirement account;
3. The value of your investment real estate (other than your personal residence), whether or not held in a LLC; and
4. The value of your small business, whether or not held in a LLC.

If the combined value of these assets exceeds $500,000, then you are an excellent candidate for an asset protection trust.

So how does the asset protection trust work?

An asset protection trust is created when a person called 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 ability 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 in that state, which means residents of those states may remain a beneficiary of the

[3] There are exceptions to this general rule. For example, Arizona law does not 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 irrevocable 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. Unfortunately the full faith and credit clause of the U.S. Constitution makes it unlikely an Arizona court would respect the governing law of a self-settled asset protection trust established in one of these states for an Arizona resident. Foreign asset protection trusts avoid this problem in theory, but if the full protection of the trust is triggered by an actual threat, case law has shown the beneficiary also loses access to the trust assets unless willing to move permanently outside of the United States. This is an unintended consequence most people are not willing to accept.

trust and protect the trust assets from their own future or unknown creditors. Although Arizona law does not permit self-settled asset protection trusts, an Arizona trustor may still obtain the desired creditor protection by establishing the trust in Arizona, excluding the trustor as an eligible beneficiary, and relying on spendthrift or discretionary trust provisions available under Arizona law to protect the trust assets from creditors of the eligible beneficiaries.

For Arizona residents, there are two options when naming trust beneficiaries:

Option #1- Family Gifting Trust (Trustor's Children are Lifetime Beneficiaries)

In Option #1 you would name one or more children (or other non-spouse beneficiaries) as eligible beneficiaries during your lifetime, 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. Although your beneficiaries would have a right to information about trust assets, you retain discretion whether to make any distributions to them during your lifetime. The trust assets will be protected from your creditors - because you are ineligible to receive distributions - and from creditors of the beneficiaries (using spendthrift or discretionary trust provisions available under Arizona law).

Option #2- Spousal Lifetime Access Trust (Trustor's Spouse is a Lifetime Beneficiary)

In Option #2 you would include your spouse as an eligible beneficiary during your lifetime, and if desired, name your spouse as trustee. Similar to Option #1 the trust assets will be protected from your creditors during your lifetime - because you are ineligible to receive distributions - and from creditors of your spouse and beneficiaries. The difference here is that your spouse is an eligible beneficiary, allowing your spouse to receive distributions from the trust 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 after partition.

Both approaches may be referred to as *hybrid* asset protection trusts because either may be drafted to include a provision giving an independent person or company called a trust protector the power to move the trust to another state or country that permits self-settled asset protection trusts. This change of governing law might permit the trust protector to add you as an eligible beneficiary later.

7. What are the tax consequences of establishing an Arizona-based Hybrid Asset Protection Trust?

The next design issue is to choose whether you want the asset protection 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 tax optimization is usually achieved by permitting you to redirect distributions during lifetime or

[5] As of 2019 the federal estate tax law exempts up to $11,400,000. This number is likely to increase annually due to inflation adjustments.

to 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 must relinquish any rights you might have to redirect distributions during your lifetime or to reallocate the trust assets upon your death. And although technically permitted with careful drafting, the safer approach is to exclude yourself as an eligible trustee.

8. May I simply gift my assets to someone else in order to protect them from creditors?

While gifting an asset outright to a spouse or other relative would clearly be fraudulent if a claim is known or reasonably foreseeable, it would also be foolish when no claim is imminent. If you gift an asset to your spouse, and then later divorces you, your ex-spouse keeps the asset and you get nothing. Likewise, your other relative would have no obligation to gift an asset back to you, or use the asset for your benefit, when you might want it back in the future. Even the act of your spouse or relative gifting an asset back to you may serve as evidence the initial gift was actually made to hinder or defraud a potential creditor.

A gifted asset is also exposed to creditor claims against the spouse or relative. For example, if your spouse is at fault in an auto accident, the asset you were trying to protect would be exposed to a potential new claim outside your control. Also consider the possibility that your relative might later get divorced and the relative's ex-spouse becomes entitled to one-half of an asset that was originally yours.

The better approach is to rely on liability insurance, LLCs, and irrevocable trusts to protect assets. Even an irrevocable trust with spousal access provisions may be drafted to define your spouse as the person you are married to and not necessarily the person you were married to at the time the trust was established. Similarly, an irrevocable trust for your children may be drafted to protect trust assets from creditors and ex-spouses of the children.

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.

Arizona-based Hybrid Asset Protection Trusts

Issue 1- Structure

A	**Family Gifting Trust** 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	**Spousal Lifetime Access Trust** Trustor's spouse is a lifetime beneficiary Individual trust required (contributions must come from separate property or trustor's one-half of community property after partition)	Beneficiary spouse may serve as trustee Trustor spouse may serve as trustee, but safer not to (and never if trust is intended to hold life insurance policy) More 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 $11.4 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