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An Introduction to Arizona Domestic Asset Protection Trusts

On May 14, 2020, the executive council for the Probate and Trust Section of the State Bar of Arizona approved a proposed statute permitting the creation of Arizona qualified spendthrift trusts. This type of self-settled trust is more commonly known as a domestic asset protection trust. The proposed statute (A.R.S. §14-10821) would establish a new framework for Arizona residents to protect personal assets from future claims in a manner consistent with and subject to Arizona fraudulent conveyances laws. If enacted, Arizona would become the 20th U.S. state to allow self-settled spendthrift trusts as an asset protection planning technique.

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.

2. What is an Asset Protection Trust?

An asset protection trust is created when a person 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 may qualify for protection from your future or unknown creditors.[1] 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 establish your own irrevocable asset protection trust and retain the sole discretion to make distributions back to yourself. This arrangement does not provide any asset protection and is against public policy in all 50 states.

[1] There are exceptions to this general rule. For example, Arizona law does not shield the trust assets from child support claims. Also, the technique is not likely to work if you transfer *all* your personal assets to the trust. You must remain solvent on your personal net worth statement, even after contributing assets to the irrevocable trust.

Some states like Wyoming and Nevada[2] already permit self-settled asset protection trusts using a third-party "qualified" trustee in that state, which means residents of those states may be named as trust beneficiaries and, after any applicable statute of limitations expires, know the trust assets are protected from their own future or unknown creditors.

3. Does Arizona allow Asset Protection Trusts?

Arizona law does not currently permit self-settled asset protection trusts like those permitted in Wyoming and Nevada, but a proposed statute permitting them may soon be enacted into law by the Arizona legislature and governor.[3] A.R.S. §14-10821 is modeled after similar statutes in other states although there are a few variations for practitioners to study.

The key provision in the proposed statute expressly states that a creditor (a) may not satisfy a claim or liability of the trustor[4] in either law or equity out of the trustor's transfer to such trust or the trustor's beneficial interest in such trust; (b) may not force or require the trustee to make a distribution to the trustor, as beneficiary; or (c) may not require the trustee to pay any distribution directly to the creditor, or otherwise attach the distribution before it has been paid or delivered by the trustee to the trustor, as beneficiary.

This level of protection is very attractive, of course, but the statute also identifies a handful of mandatory provisions that must appear in the trust document and articulates an assortment of notice and contemporaneous recordkeeping requirements, exceptions to the general rule, and variable statutes of limitations. In sum, the statutory protection is attainable but entails a process that must be handled with precision.

4. What are the drafting requirements for an Arizona Qualified Spendthrift Trust?

The following are some of the mandatory provisions to qualify a trust as an Arizona Qualified Spendthrift Trust under the proposed statute:

- The trust document must clearly state that the trust is governed by Arizona law and established pursuant to A.R.S. §14-10821.
- The trust document must require that at all times at least one trustee is a qualified trustee as defined in A.R.S. §14-10821(A)(5).
- The trust document must include a spendthrift provision.

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[2] Currently 19 states permit self-settled asset protection trusts in some variation. The most well-known are Alaska, Nevada, Wyoming, and South Dakota. Unfortunately, the full faith and credit clause of the U.S. Constitution makes it uncertain whether 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.

[3] However, Arizona residents can contribute assets to a third-party discretionary trust, i.e., for other beneficiaries, that would be protected under current law. Also, Arizona residents may also establish an asset protection trust in a state that permits them although the effectiveness of this technique is uncertain.

[4] The term "trustor" is interchangeable with the term "settlor" and both refer to a person who contributes an asset into trust. The proposed statute uses the term "settlor."

- The trustor must be irrevocable.
- The trustor may not have a right to revoke assets from the trust; except, however, a provision is allowed permitting the trustor to substitute assets of substantially equivalent value.[5]
- The trust document must not provide for any mandatory distributions of either income or principal to the trustor.

5. What is a qualified trustee?

"Qualified trustee" means a person, other than the trustor, who meets all the following conditions: (a) An individual who resides in Arizona or an Arizona-licensed fiduciary; (b) the trustee must maintain or arrange for custody in Arizona of some or all the trust property; and (c) the trustee's usual place of business or residence is in Arizona.

There is no rule prohibiting a trustor from serving as a trustee.[6] However, a qualified trustee is always mandatory to maintain the trust as a qualified spendthrift trust.

6. What powers may be reserved by the trustor?

The following are some of the powers that may be retained by the trustor under the proposed statute:

- The trustor may give a personal guarantee on a debt or obligation secured by trust property.
- The trustor may make payments on a debt or obligation secured by trust property.
- The trustor may pay property taxes, insurance premiums, HOA dues, maintenance expenses, or other similar expenses on behalf of trust property.
- The trustor may pay income tax attributable to trust property if the trust is deemed a grantor trust for income tax purposes.
- The trustor may retain the power to remove and replace a trustee, trust protector, or advisor; and to direct trust investments and execute other management powers.
- The trustor may retain the power to consent to or veto a distribution from the trust.
- The trustor may retain a limited lifetime or testamentary power of appointment.

7. Does the Arizona statute include exceptions for child support or alimony?

Yes, the proposed Arizona statute requires the trustee to notify anyone who holds a "specified domestic obligation" against the trustor at least 30 days before making any distribution to the trustor. This exception may refer to either child support or alimony.

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[5] This provision is often used to ensure grantor trust status for income tax purposes.
[6] However, a trustor is usually prohibited from serving as a trustee if the trust is drafted as a completed gift trust in order to exclude its assets from estate tax inclusion.

8. Are there any limits to the value of assets that may be contributed to an Arizona Qualified Spendthrift Trust?

Yes. A transfer of assets to the trust may not render the trustor insolvent as defined A.R.S. §14-10821(A)(3).[7]

9. Does the Arizona statute require completion of an affidavit upon each transfer into trust?

Yes, and this requirement may be a hassle. Section A.R.S. §14-10821(E)(11) requires a trustor to sign an affidavit at the time any asset is transferred into the trust. The affidavit must state all the following in substantially similar form:

- The trustor has full right, title, and authority to transfer the assets to the trust.
- The transfer of the assets to the trust will not render the trustor insolvent.
- The trustor does not intend to hinder, delay, or defraud a known current creditor by transferring the assets to the trust.
- There is no pending or threatened arbitration proceeding or court action against the trustor, except for pending or threatened court actions and proceedings identified by the trustor on an attachment to the affidavit.
- The trustor is not involved in an administrative proceeding that is reasonably expected to have a material adverse effect on the financial condition of the trustor, except an administrative proceeding identified on an attachment to the affidavit.
- At the time of the transfer of the assets to the trust, the trustor is not in default of a specified domestic obligation.
- The trustor is not currently contemplating filing for relief as a debtor under the provisions of United States Code, Title 11, Bankruptcy.
- The assets being transferred to the trust were not derived from unlawful activities.

10. What Statutes of Limitations will apply to potential creditor claims?

The proposed statute includes variable statutes of limitations depending on the timing of the cause of action and the type and timing of a formal notice as it relates to a specific transfer to the trust.

Type of potential creditor	Statute of limitations
A potential creditor known to the trustor who is given actual notice of the transfer	6 months
Any potential creditor – known or unknown - after formal notice of the transfer is published	4 years

[7] "Insolvent" means: (a) having generally ceased to pay debts in the ordinary course of business other than as a result of a bona fide dispute; (b) being unable to pay debts as they become due; or (c) being insolvent within the meaning of federal bankruptcy law.

A potential creditor whose cause of action or claim for relief arose before the transfer	The later of 4 years after the date of the transfer, and 1 year after the transfer is or reasonably could have been discovered through the exercise of reasonable diligence by the creditor
A potential creditor whose cause of action or claim for relief arose concurrent with or after the transfer	The later of 2 years after the transfer is made, and 6 months after the transfer is or reasonably could have been discovered through the exercise of reasonable diligence by the creditor

Essentially, the optional publication of formal notice in a newspaper starts a 4-year countdown to the moment when a transferred asset is secure in the trust. But the countdown clock can be shortened to as little as 6 months by providing actual notice of a transfer to a potential creditor or possibly extended in some cases if no formal notice is published and the potential creditor had no reason to be aware of the transfer for more than 4 years.

11. How effective will an Arizona Qualified Spendthrift Trust be?

The level of protection appears formidable, but anyone who practices law in this area knows that self-settled asset protection trusts are risky because so few cases involving this type of trust reach the appellate courts for review.[8] Some practitioners who disfavor asset protection trusts point to the cases when asset protection trusts failed in order to argue against their effectiveness, but those cases are few and they tend to have abusive facts that support the court's ruling. Also, others oppose self-settled asset protection trusts as bad public policy.[9]

A safer approach – which already exists – is to establish the asset protection trust as a third-party discretionary trust. This "hybrid" approach omits naming the trustor as an initial beneficiary (i.e., not self-settled) but permits an independent person or company called a trust protector to later add the trustor as an eligible beneficiary if desired, subject to the then-applicable qualified spendthrift trust rules.[10] But until then the trust relies on spendthrift or discretionary trust provisions already well-established under Arizona law to protect the trust assets from creditors of the eligible beneficiaries.

[8] On the other hand, proponents argue that the few number of appellate cases is proof the trusts work effectively because creditors are forced to agree to settlements.

[9] But to be consistent these opponents of asset protection trusts should also be against the use of corporations, LLCs, and discretionary trusts because they offer similar liability protection. One wonders what the effect on entrepreneurism in America would be if these long-accepted asset protection techniques were taken away.

[10] Alternatively, a trust protector could change the governing law of the trust to any other state or country that permits self-settled asset protection trusts.

12. How do you structure an Arizona-based Hybrid Asset Protection Trust?

For Arizona residents, there are two options when naming beneficiaries of an Arizona-based hybrid asset protection trust:

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 full control of the assets in the irrevocable trust.[11] 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 are protected from your future or unknown 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 (or simply wait until Arizona permits them). This change of governing law might permit the trust protector to add you as an eligible beneficiary later.

13. 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[12], 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 to reallocate the trust assets upon your death to different beneficiaries than you initially named in

[11] However, a qualified trustee will be required to make the trust qualify as a Qualified Spendthrift Trust if Arizona enacts the proposed statute.
[12] As of 2022 the federal estate tax law exempts up to $12,060,000. However, this number is subject to the political winds of change.

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 reallocate distributions among beneficiaries 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.

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 $11.7 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