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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 $425,200 of equity in a personal residence.[2]
2. The investment component of life insurance policies and annuity contracts.[3]
3. Assets held in a tax-advantaged retirement account, such as 401k and IRA.

But these exemptions do not work for everyone.

Many people own brokerage accounts holding non-retirement investments. 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 known creditors, i.e., creditors who have already brought a cause of action or claim for relief; or provide immediate protection from potential creditors when an applicable statute of limitations applies. I will not represent anyone who expresses intent to hinder, delay or defraud any known or reasonably foreseeable creditor. A client must be willing to sign an affidavit evidencing intent to remain financially solvent after any transfer and to refrain from fraudulent transfers.

[2] The homestead exemption amount is adjusted annually for inflation.

[3] Life insurance policies and annuity contracts must be in force for at least 2 years to qualify.

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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 recommend you maintain 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 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 inside liabilities of the LLC.

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.

On the contrary, a single member LLC will not protect you in the above example if the matter is being litigated in a federal bankruptcy court. There is substantial precedent for the bankruptcy court to treat a single member LLC differently than a multi-member LLC. The court will disregard the single member LLC and Arizona law when there is an outside liability creditor attempting to penetrate the LLC. If you are concerned about this kind of liability then think long and hard before filing for bankruptcy.

5. Will a LLC 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. The typical small business provides a service or product, or both, to the public, while investment real estate provides a place to live or do business.

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

Arizona residents qualify automatically for a homestead exemption, which protects up to $425,200 of equity even if a court forces the sale of the home to satisfy a creditor trying to collect a judgment

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against you. For homeowners with more equity than the homestead exemption provides, I may recommend increasing homeowner liability insurance coverage or retitling the home into an irrevocable Arizona home equity protection trust.[4] Neither solution requires a business purpose to implement.

Other reasons you should not transfer your personal residence into an 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 an LLC unless perhaps combined with other assets that do have a business purpose.

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 or 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 the current Arizona homestead exemption amount;
2. The value of your financial investments (cash and non-retirement investment accounts, etc., but excluding tax-advantaged retirement accounts);
3. The equity in your investment real estate (other than your personal residence) if held outright or in a single member LLC; and
4. The equity in your small business, if held outright or in a single member 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 an Arizona-based asset protection trust work?

An Arizona-based asset protection trust is created by transferring certain types of assets into an irrevocable trust and naming other people as beneficiaries (excluding yourself). The assets you contribute are generally protected from your future or unknown creditors.[5] The catch is that you cannot name yourself as a beneficiary like you would normally in a standard revocable living trust used 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.

[4] The Arizona Home Equity Protection Trust is a slightly modified version of the Arizona-based Hybrid Asset Protection Trust because its primary objective is to protect home equity in the primary residence.

[5] 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* your personal assets to the trust. You must remain solvent on your personal net worth statement, even after contributing assets to the irrevocable trust.

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Some states like Wyoming and Nevada[6] already permit self-settled asset protection trusts using a third-party "qualified" trustee in that state, which means residents of those states may remain a beneficiary of the trust and, after any applicable statute of limitations expires, 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 a high degree of 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, I recommend 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 full 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 are protected from your future or unknown creditors 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 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.[7]

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.

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[6] Currently 20 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.

[7] In practice this arrangement is somewhat unusual. It is most common in a second marriage situation where one spouse brings a substantial amount of separate property into the marriage and works in a high-risk profession or business.

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7. What about the tax consequences of establishing an 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[8], 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 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.

8. May I simply give my assets to someone else to protect them from creditors?

While giving an asset outright to a spouse or other relative would clearly be fraudulent if a claim is known or reasonably foreseeable, it may also be foolish when no claim is imminent. If you give an asset to your spouse, and then your spouse later divorces you, your ex-spouse keeps the asset and you get nothing. Likewise, your other relative would have no obligation to give 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 made, in fact, 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 irrevocable trusts, liability insurance, and LLCs, to protect assets. For example, 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.

[8] The federal estate tax law exempts up to $13,990,000 for persons who die in 2025. However, this number is subject to the political winds of change.

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About the Author

Thomas J. Bouman provides legal counsel in the areas of estate planning, estate administration, 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 the author of the Arizona Estate Administration Answer Book and a prominent member of WealthCounsel, the nation's premiere organization of estate planning attorneys.

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Arizona-based Hybrid Asset Protection Trusts

Issue 1- Structure

A	**Family Gifting Trust** Trustor's children (or other people) 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 Simpler 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 Allows trustor to change the residual beneficiaries who inherit after death of trustor	Trust assets will be included in the trustor's taxable estate, which will trigger tax if taxable estate exceeds the exempt amount (currently $13.99 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 after death of trustor	No step-up in income tax basis upon death Must be willing to lock in beneficiaries when trust is created

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