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What You Should Know About Arizona Home Equity Protection Trusts

1. What is an Arizona Home Equity Protection Trust?

An Arizona home equity protection trust ("HEPT") is an irrevocable trust designed to shield your home equity from future and unknown judgment creditors. If your primary residence is high in value, and you have accumulated substantial home equity, then your home may become a prime target when someone accuses you of wrongdoing (whether legitimate or fraudulent). You may already know that Arizona law protects up to $425,200 of home equity in a primary residence automatically (the "homestead exemption"), but homeowners with more home equity than provided by the homestead exemption should consider retitling their primary residence into an irrevocable HEPT. For example, if your primary residence is worth more than $1 million and you own it free and clear, then you have more than $500,000 exposed to future threats against you. An irrevocable HEPT trust can provide you with additional peace of mind because you will know that no one can force you to move out of your home.

While it is possible for an irrevocable trust to be funded with an assortment of assets, the primary residence is usually the one that gets the most attention. If you are like most people, your home is your castle, and you do not want to lose it.

2. How does a Home Equity Protection Trust work?

Although Arizona does not permit self-settled asset protection trusts like many other states do, Arizona residents can establish a hybrid asset protection trust by transferring certain types of assets into an irrevocable trust and naming other people as beneficiaries (excluding yourself).

The irrevocable HEPT works to protect your home equity because you no longer *own* the home but instead retain an exclusive right to *occupy* the home without restriction. If the home is later sold, the net proceeds remain in the trust and may be distributed to the named beneficiaries at the discretion of the trustee (who might be you). You may name your children, grandchildren, or other individuals as the beneficiaries.

3. What if I want to be a trust beneficiary?

To make the trust achieve its primary objective under Arizona law, the trust must exclude you as an eligible beneficiary. However, an irrevocable trust document may be drafted with a hybrid approach that provides some flexibility. Using a hybrid approach means 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 wait until Arizona permits them). This change of governing law might permit the trust protector to add you as an eligible beneficiary later. However, you should only retitle your home into an irrevocable HEPT when you are confident that you will not need to liquidate the home equity for your own spending needs.

4. What is the homestead exemption, and how does it work?

Arizona law provides a homestead exemption that protects up to $425,200 of equity in your primary residence from creditor claims. The exemption amount is adjusted annually for inflation. No action is required to claim it. The Arizona homestead exemption is available for single-family homes, condominiums, and manufactured homes, but not rental properties or secondary homes.

The Arizona homestead exemption is complicated by federal bankruptcy laws. If the home was acquired within 1,215 days (3 years, 4 months) of filing the bankruptcy case, the exemption amount is currently limited to $189,050. If this rule applies to you, be sure to investigate further with a bankruptcy attorney because there are exceptions that may help you out.

If you have less than or equal to $425,200 of home equity in your primary residence, an Arizona court cannot evict you from your home, force a sale, and permit a creditor to collect a judgment against you. But if you have more home equity than the homestead exemption amount, then your home equity is exposed if you become liable for wrongdoing (whether legitimate or fraudulent). A court could evict you and force a sale. You will receive the protected amount in cash, but the remaining proceeds from the sale are available to the creditor. Meanwhile, you are forced to find a new place to live. A Home Equity Protection Trust would have prevented this outcome, and perhaps even discouraged the potential creditor from bringing a claim in the first place.

5. Are there restrictions against selling the home?

No, the trustee can sell the home without restriction. However, the net sale proceeds must be retained in a cash or investment account titled in the name of the trust. The trustee may use the sale proceeds to purchase a new home for you or distribute the funds to the lifetime beneficiaries (usually children, grandchildren, or other relatives).

6. Can the beneficiaries be changed?

Yes, you may retain the right to change the lifetime beneficiaries whenever you desire, but you cannot add yourself as a beneficiary. You will also have the right to change the residual beneficiaries who inherit from the trust after your death.

7. May I serve as trustee of the trust?

Yes, Arizona law permits you to name yourself as the trustee of the trust. However, it is safer to name someone else as the trustee. By doing so, you can fend off an argument by a creditor that you indirectly retained a right to give trust assets back to yourself. Whether you name someone else as the trustee may depend on whether you trust someone else in this role and how much potential liability you perceive yourself to have.

8. May I contribute other types of assets into the trust?

Yes, nothing prevents you from contributing other assets to the trust such as non-retirement brokerage accounts and rental properties. However, I choose to focus on protecting the primary residence because this is usually the asset that clients care most about protecting. The primary residence is a good candidate for placing into an irrevocable trust because the client gives away indirect access to home equity but not direct access to any investable funds.

9. What are the disadvantages of a Home Equity Protection Trust?

The primary disadvantage of a HEPT is that you lose the ability to refinance an existing mortgage loan or qualify for a new mortgage. While an irrevocable trust technically permits its assets to be used as collateral for a loan, it is very difficult to find a mortgage company willing to lend money to an irrevocable trust. Thus, the HEPT works best if you own your home free and clear or if your existing mortgage has an interest rate low enough to dissuade you from the need to refinance. Similarly, you would not be able to secure a cash-out refinance for the same reason.

A secondary disadvantage of a HEPT is the hassle and cost of retaining a qualified lawyer to establish it. Any type of irrevocable trust requires extensive experience and specialized knowledge to draft properly. This limits the availability of HEPTs because not all estate lawyers know how to draft them and those that do will likely charge a high fee to establish one.

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.