

## THE TOP 10 REASONS 21ST-CENTURY COUPLES SHOULD CONSIDER A PRENUPTIAL AGREEMENT: PART 1

*First in a two-part series*

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*This article was published in Elite Advisor Forum. Reprinted with permission.  
January 12, 2011*

### OPPORTUNITY TO ELIMINATE TRANSFER TAXES ON GIFTS

As a savvy financial advisor, you're aware that spouses are not mere roommates. They are partners, with each individual assuming obligations to support the other during their marriage and with each being entitled to certain marital property rights, depending upon their circumstances and where they live.

Marital property laws vary widely. Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin are community-property states, in which spouses are generally treated as full economic partners.

#### **READER NOTE: IN 1998, Alaska adopted a form of community property law.**

Community property wealth derived during the marriage is owned jointly in equal, present, undivided interests. Each spouse owns or controls the disposition of 50 percent of the marital community upon divorce or death. Beyond these fundamentals, state-by-state variations are significant.

The remaining states are common-law jurisdictions. Each spouse owns what he or she earns or receives. The non-earning spouse is entitled to support, but does not control property earned or accumulated by the other spouse. In

### KEY TAKEAWAYS

- Prenuptial agreements are not one-size-fits-all, and the conflict of law issues can be complicated.
- Marital property rules vary from state to state. Couples that marry without a prenuptial agreement have opted for the marital property regime of the jurisdiction where they married, subject to the later effects of the laws where they may be domiciled from time to time.
- A couple that prepares a prenuptial agreement has chosen to craft marital property rules that address its unique circumstances. A prenuptial agreement may not always be effective to mitigate the conflict of law issues, but it is better than silence on the issue.

the event of divorce, the court makes an equitable division of marital assets. Upon the death of the owner spouse, the surviving spouse is generally entitled to a minimum (elective) share of the owner spouse's estate.

Common-law marital assets can be transformed into "quasi-community property" if a couple moves to certain community property jurisdictions. This generally comes as a nasty surprise to the spouse whose name is reflected as the sole owner of the assets.

Keep in mind that couples planning to bring substantial common-law marital property to any community property state (especially California,

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Louisiana, Washington and Wisconsin) are advised to seek the advice of family law or estate planning counsel prior to their move. A discussion of specific state marital property rules is beyond the scope of this short article. Local estate planning and/or family law counsel should be consulted regarding specific property rights and obligations or entitlements relating to spousal and child support.

### **MAYBE EVERYONE NEEDS A PRENUPTIAL AGREEMENT**

Since the various state law marital property systems can wreak havoc on rights that a couple might think they acquired in property during their marriage, and since the mix of state laws is so confusing – then, unless the couple is going to live in the same jurisdiction throughout their marriage, should every couple with individually accumulated assets prior to marriage consider a prenuptial agreement?

Not necessarily.

State marital property rules should be adequate for couples starting out with few assets or liabilities and who will build wealth together. If the couple has accumulated significant wealth and must change their domicile, they can consider a postnuptial agreement. But no shortcuts are allowed! Each spouse MUST have independent representation.

### **FIVE REASONS TO CONSIDER A PRENUPTIAL AGREEMENT – VARIATIONS ON A THEME**

Here are five excellent reasons for a couple contemplating marriage to consider a prenuptial

agreement when one or both of them bring substantial separate property to their future marriage:

#### **Segregate Inherited Wealth**

It is the nature of inherited wealth that the senior generations, be they alive or dead, are third parties in the marital relationship. A prenuptial agreement will draw boundaries around, and set ground rules regarding, the couple's use of inherited wealth. Two reasons for (goals to be accomplished with) these prenuptial agreements are as follows:

**REASON 1. *Avoid diluting/maintaining control of inherited wealth.*** The primary goal here is to have effective segregation of the inherited funds. Commentators have claimed that this can be accomplished with trust arrangements. As California lawyers, we believe that no trust can be relied upon to protect an inheritance. Inherited property held in an irrevocable discretionary trust is presumed to be available for support (if the heir is the **supported** spouse). A pattern of past distributions will be presumed to continue, for the purposes of calculating spousal support (if the heir is the **supporting** spouse). An inherited interest in a family business may not retain its separate property character if the beneficiary actively manages the business and is not adequately compensated for those efforts. A prenuptial agreement is the appropriate tool for the job.

**REASON 2. *Keep a family business that will be managed by the new spouse in the family.*** In this example, the inherited business interest is simultaneously a quintessential marital asset

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(the business maintained/built up by the working spouse/heir during the marriage) and an inherited asset. Expect the court to give preference to the “marital asset” character over the “inherited asset” character. In California, the intangible value of the business attributable to the spouse/heir’s efforts during the marriage can become the dominant factor in the value of the business over the course of the marriage. The only way to ensure that the underlying equity value or voting control of the family business remains the heir’s separate property is with a prenuptial agreement.

### **Maintain Specific Separate Wealth**

Reasons Three and Four are variations on the “Inherited Wealth” theme. The different relationship that the owner has with his or her property tends to change the dynamics of the negotiation of the prenuptial agreement.

### **REASON 3: *Maintain control of specific separate property assets; manage expectations.***

In this case, the separate property coming into the marriage can be anything – an investment property/project, a portfolio, even a residence. The spouses’ respective words, conduct and unspoken assumptions can create confusion. A prenuptial agreement can avoid ambiguities regarding the character of these separate property assets over the passage of time. Opportunities for expensive-to-litigate he-said/she-said arguments can also be foreclosed. For example, the non-owner fiancé may expend personal skill and effort in the management of an asset owned by the other fiancé and may expect to become a co-owner of the asset after the marriage (based

upon premarital and post-marital efforts). The owner fiancé may view his or her beloved as generously having given of his or her time with no expectation of becoming a co-owner. The owner fiancé may view the separate property asset as something that he or she must preserve at all costs, or he or she may be possessed of a self-confidence that allows him or her to be more generous. Prenuptial agreement negotiations will help to uncover miscommunications that the fiancés may not even realize exist and may provide them an opportunity to sort out these issues.

### **REASON 4: *Maintain separate property ownership of a business; limit marital property to compensation paid to the owner spouse during the marriage.***

In this case, the owner fiancé is an entrepreneur, professional, artist or entertainer. The couple wishes to have marital property from earnings without risking the entrepreneur’s ownership and control of the business. The owner spouse is directly responsible for the existence of the business (either alone or in partnership with a co-owner). His or her efforts have everything to do with the success of the business. The prenuptial agreement allocates reasonable compensation to marital property. Equity in the business and all income, gains, appreciation, distributions, etc., from the business remain separate property. All control over the business interest remains with the entrepreneur. When the entrepreneur effectively sets his or her compensation, an objective measure may be needed as a surrogate for “reasonable compensation” to avoid crafting a prenuptial agreement that is unenforceable for lack of a meaningful promise.

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When the entrepreneur is an entertainer or artist, it is essential to control how marital property rights may attach to the entrepreneur's residuals, intellectual property rights, and even physical objects such as master recordings, manuscripts, artworks, etc.

### Simplify the Situation

**REASON 5: *Both fiancés are wealthy. For the purposes of this discussion, the source of the wealth is not the issue.*** Each fiancé is economically independent and is expected to remain so. Neither needs marital property. A prenuptial agreement can prevent marital property law (whether common-law or community property law) from complicating their economic relationship. The prenuptial agreement should also establish conventions that will reduce accounting burdens that can arise in a "no community/marital property" agreement (especially if there is no family office or neither spouse has a separate business manager). Incidentally, the prenuptial agreement negotiations should uncover whether the parties are being honest about their financial circumstances and whether they both belong in this category.

### PRENUPTIAL AGREEMENT: YES OR NO?

One way to look at it is that, without a prenuptial agreement, in fact of law a marital property agreement is imposed upon every couple. It is the one written for them by the statutes and case law developed in the state where they marry, as amended by the statutes and case law developed in each state where they may be

domiciled during their marriage. This haphazard approach seems to work for "happily ever after" couples who build their life from nothing – "until death do they part." For everyone else, the marital property rules created by the state could probably use some tweaking, but at what cost, emotionally and financially?

A better way to look at it is that a custom-drafted prenuptial agreement should be created only if it can help the couple solidify the partnership that they need to develop for their marriage to succeed. Accomplishing that requires the parties to be as fair, honest and understanding with one another as they can. It also requires attorneys on both sides of the table who know family law, estate planning and relevant tax issues. They must also help their clients understand possible outcomes of their final decision (both positive and negative) and work cooperatively to create an agreement that works for both parties.



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