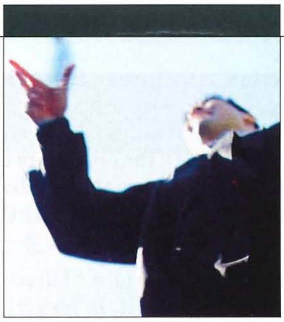

Marital Agreements: Wealth Conservation Tool for Estate Plans

A customized marital agreement is far more likely to carry out a couple's financial desires than would impersonal state statutory frameworks.

PAM FRIEDMAN

Paul Simon told us there are "Fifty ways to leave your lover." Only two choices are available, however, for "ways to leave a marriage"—divorce or death. With that in mind, estate planners should not overlook that divorce planning is a component of financial planning.

The purpose of financial planning is to protect money and meet financial goals. Advisors check that clients have property insurance in case of fire, and life or disability insurance in case income is no longer there to support loved ones. Advisors also make sure assets are protected from creditors and that investments and succession plans are in line with financial goals and risk tolerance. But what can be done to reduce the financial impact of divorce? Craft a marital agreement.

A marital agreement is simply a tool to achieve a degree of certainty for a client's financial future by managing the financial risk of divorce. The road to an executed agreement, however, is no easy task. Bringing up the idea of marital agreement is considered unromantic and for some, unthinkable. To counter this mindset, advisors need to present the idea as necessary and responsible. Agreements should be thoughtful, comprehensive, and purposeful. Otherwise, the state will prepare one under family law. And those laws will likely fit like an oversized, itchy sweater.

Spearhead the conversation

Marital agreements are often viewed as necessary only for the wealthy—as protection for the wealthier spouse. But the agreement should be structured and negotiated to protect the financial (and emotional) future of both bride and groom. This is a much more straightforward task when the couple is happy and supportive than when they are feeling maligned in divorce. Even couples of modest means may need an agreement to provide clarity—especially if the couple purchased assets or real estate together before marriage, plans to live during marriage in a separate-property home, or simply if one or both have separate property they want to keep separate (e.g., a business or employee benefits like stock options).

To adequately assist newlyweds or any other couple, financial and estate planners must educate themselves and their clients about family law as it relates to the division of assets in their state. As a financial analyst working with divorcing individuals, the present author can attest to the fact that most people are surprised by the one-size-fits-all financial terms of income and asset division under family law. Once couples understand the law, they are much more open to the idea of a marital agreement.

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Financial goals depend on how the marriage ends

Financial goals differ depending on whether the couple is thinking about the risk of divorce or death.

The risk of death is 100%, so couples often focus on this in estate plans, believing that their estate plan will be sufficient to protect their assets. Early on in a marriage, one may want to protect a new spouse but may not want to leave one's entire estate to someone known for only a short time. In a will, a financial or estate planner might suggest terms that include something like the following: Bill could put the residential home he had before marriage into a testamentary trust, naming his new wife, Susan, as a beneficiary with the right to use the home for her lifetime. After her death, the trust would benefit other family members.

For second marriages in particular, another possibility is life insurance. Assuming life insurance options are available, Bill could prepare a new will leaving his estate to his children and agree to purchase life insurance for the benefit of Susan. But what if Bill fails to pay premiums? When that is a concern, the couple would need to add additional terms until both were satisfied with the agreement.

While couples often focus on their estate plans, they often overlook the risk of divorce. Who wants to talk about divorce when love is in the air during the early stage of marriage? But like estate planning, couples should and must consider this statistically significant possibility. Bill is fine with leaving a life estate to his new wife if he dies but wants the residential home to remain separate property and not available for division in divorce. He can make these wishes understood in a marital agreement. His new wife, Susan, might want to keep her assets separate as well.

Ideally, marital agreements should be created in conjunction with a solid estate plan. This can be done through planning that includes a marital property agreement, or with a will-based plan and a separate marital property agreement. While they do not have to be completed at the same time, couples should make sure that their attorneys are aware that both exist. It is far too easy to defeat or complicate an estate plan with a marital property agreement that contradicts the terms of that plan, or vice versa. If done correctly, however, the two areas of planning should complement one another and provide clarity—not confusion.

Creating and negotiating a marital agreement

Planning a marital agreement starts with financial planning. When couples are able to fully disclose their financial resources to each other and agree on how to divide those in the event of a divorce, they enter marriage with security, clarity, and confidence. This is particularly true for older couples who have little or no time to recover financially from a devastating divorce.

The next step in planning a marital agreement is to *define goals and create solutions that meet those goals.* Often the objective for a non-working or low-wage spouse in case of divorce is to have a place to live (and some cash) while their soon-to-be-ex wants to limit what the law might permit, minimize taxes due to asset division, or avoid asset liquidation. Offering or accepting a specific cash amount that grows with the marriage feels awkward—as if a new spouse is being paid for "service" to the relationship. But a cash amount can work when it is explained in the context of a spouse's legal right to income or assets—rights one may "give up" under the law in favor of an agreement.

Allocating real estate under a marital agreement, on the other hand, does not have as much of a stigma. But it is typically illiquid and may present other unintended consequences, particularly if the agreement is not updated regularly. One of the first prenuptial agreements the author reviewed generously allocated the future husband's multimillion dollar home to his fiance after several years of marriage. In a meeting, the author discussed with the husband the risk that the home might not sell quickly, leaving the spouse with little or no liquidity during the process of divorce and potentially bankrupting her after. He changed his mind and allocated a specific amount of liquid investments instead.

Finally the couple must *maintain their agreement.* Just like a will, couples should keep the marital agreement simple but be encouraged to review it periodically and when major asset sales or purchases occur. This ensures that the intended consequences of the agreement are preserved as the couple's assets change over time.

Using trusts as part of a marital agreement

Asking one's future spouse to enter into a prenuptial agreement could backfire into a fight over trust in the relationship and the expectation of divorce. In fact, in a 2008 poll, only 41% of Americans indicated that they might sign a prenuptial agreement if their partner asked them to sign one.[1] Attorneys hesitate to write them because they must be "fair," and fairness is in

1 "Americans Split on Prenuptial Agreements, According to New Thomson West Poll," PR Newswire, 2/15/2008, available at www.prnewswire.com/news-releases/americans-split-on-prenuptial-agreements-according-to-new-thomson-west-poll-56944917.html (last visited on 1/4/2016).

the eye of the beholder—often a judge in the case of divorce.

From a financial planning perspective, this line of thinking is misguided. Wills and estate plans are drafted even though they might be challenged. Why not consider pre- or post-marital agreements? With careful and clear preparation, full financial discloser, education, and upkeep, agreements will hold up.

One alternative to an agreement is an irrevocable trust. Trusts, like domestic asset protection trusts (DAPTs), work mainly when prepared prior to marriage. These trusts are irrevocable, self-settled, and name the settlor as the beneficiary. They also contain a spendthrift clause which restricts the transferability of a beneficiary's interests in the trust property. While the extent of protection depends on state law, the benefit is broad creditor protection which includes protection from a spouse in case of divorce.

The downside of a trust arrangement, when compared to a marital agreement, is a lack of flexibility. If there is a change of heart or a cash need beyond limitations, the trust cannot be unwound. Further, if assets are transferred to an irrevocable trust during marriage as a means of "divorce planning," a judge can order the trust dissolved or for the settlor to pay half the value of the transferred assets to his or her spouse without dissolving the trust.

One-sided planning ideas like an irrevocable trust can leave a bad taste and can cause more problems than they resolve. A divorcing spouse will likely feel denigrated by the trust's existence and might not just "go away" without a fight. Advisors should point out the legal, emotional, and financial costs of these structures and encourage disclosure.

The best strategies include the agreement of both spouses and use of trusts only as tools to meet a couple's financial goals. To do this in a sustainable way, clients should be encouraged to bring their soon-to-be or existing spouses into the conversation. Advisors can convince couples that planning in case of divorce provides clarity and improves the couple's confidence in each other and in the marriage. This works best when couples take the time to understand their state's laws as they relate to the protection of assets and the division of assets in divorce and agree that the scheme works for both of them in case of divorce.

Couples should keep the marital agreement simple but be encouraged to review it periodically and when major asset sales or purchases occur.

Negotiating an agreement

Depending on state law, analysts primarily use projections of future community income (income from separate property or lifestyle analysis) as a basis for discussion and negotiation. By agreeing to a marital budget upfront, couples may avoid the costly fights and some of the emotional strain of divorce.

Example. Bill has a $20 million investment portfolio that earns income of 2%. Bill marries Susan, who has no assets prior to marriage. Susan quits her new job as a teacher to help decorate Bill's new home and travel with him.

Eight years later, Susan wants a divorce. Bill says that they spent their marital income on travel and Susan's medical bills. Now there is nothing left except his separate property. Susan says that Bill told her that their new $1 million vacation home was a "gift" to her, and she thinks she has the love note from Bill to prove it.

A costly fight ensues. Susan claims Bill wasted all the money on expensive trips for himself. Bill says Susan became depressed and refused to go on the trips they planned. After hundreds of thousands of dollars of legal fees, Susan leaves the marriage with her clothes, some jewelry and, because they live in Texas, only limited alimony.

Education about the law and clarity about the financial outcome of divorce might have avoided this outcome. Earlier in the marriage when things were good, Bill and Susan could have agreed that their community income was $400,000 and that together they would spend or invest $250,000 per year. As for the other $150,000, they would add $75,000 a year to a trust or an investment account for Susan and $75,000 for Bill. Each could invest or use his or her own account without restriction. If they divorced, the balance of the accounts would transfer to each party.

Of course, couples need to understand how to maintain and update their agreements and investments. Whether trusts structures are useful will depend of the couple's unique situation, state laws, and the need to protect assets or other family members.

Conclusion

Divorce is an unwelcome topic at the beginning of or in a happy marriage but it is that happy state of mind that helps both financial planners and attorneys provide clarity. Advisors can bring couples together to create a thoughtful, purposeful plan that protects the future financial lives of both partners. Without such a plan, couples are left with fights over the fairness of the law and the unpredictability of the divorce process. ■