Insight on Estate Planning

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4 common misconceptions about prenuptial agreements

When it comes to marriage, money can be an emotionally charged subject. But few topics evoke a more passionate response than the prenuptial agreement. Despite their reputation as romance killers, however, prenups can be an effective way for many couples to achieve their financial and estate planning goals.

To recognize the potential value of prenups, however, you first need to discard the many misconceptions that surround them. Here are four of the most common ones.

1. Prenups lead to divorce

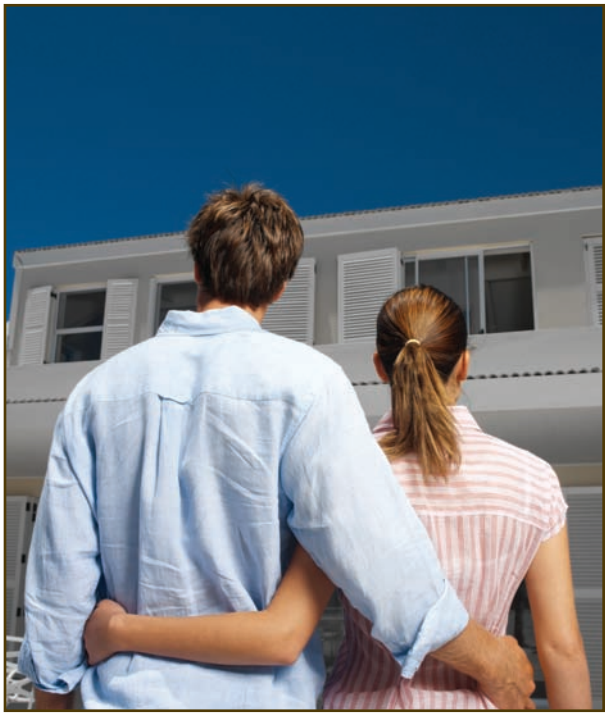
Having a prenup doesn't cause divorce any more than buying auto insurance causes you to have a car accident. Think of a prenup as marriage insurance. Like auto insurance, you hope you'll never need it, but you'll be glad you have it if the worst happens.

A recent Harvard Law School study concluded that a solid prenuptial agreement actually *improves* the chances of a successful marriage by getting couples to talk about what kind of marriage they want and what the legal consequences should be if one spouse veers off course.

2. Prenups are only for the rich and famous

Celebrity prenups typically make the gossip pages, but such agreements can be valuable tools for any couple that wants some control over what happens to their assets in the event of divorce — or death.

From an estate planning perspective, prenups are particularly useful if you have children from a previous marriage or you own a business you wish to leave to family members who work in the business. Most states give the surviving spouse rights to a substantial portion of the deceased spouse's estate, regardless of the terms of the will.



In community property states, for example, the surviving spouse has a 50% interest in all community property, which includes most property acquired during the marriage (other than by gift or inheritance). Most other states give the surviving spouse the right to an elective share of the deceased spouse's estate (one-third, for instance) that supersedes the will.

These rights can easily derail your plans, but a carefully drafted prenuptial agreement can override them and ensure your wishes are carried out.

3. Asking for a prenup is like saying "I don't trust you"

On the contrary, preparing a prenup encourages an open discussion of financial matters and requires each person to fully disclose all of his or her assets, liabilities and income sources. If a prenup doesn't include a complete financial inventory, there's a risk that it later will be challenged on the grounds that one spouse didn't fully understand what he or she was agreeing to.

Even if you and your betrothed trust each other implicitly, it's useful to spell out your wishes clearly to make sure there's a meeting of the minds and there are no surprises down the road. And even though you may feel confident that your future spouse would never exercise the right to "take against the will," what if he or she becomes incapacitated and has left the decision to a guardian or other designee? A prenup can ensure that both spouses' wishes are clearly communicated to all concerned.

4. A prenup takes advantage of the "poorer" spouse

It's true that affluent people sometimes insist on prenups to prevent new spouses from laying claim to their assets in the event the marriage fails. But a prenup doesn't necessarily take advantage of the less wealthy spouse.

Courts are unlikely to enforce a prenup that would leave a spouse destitute. Typically, both parties to a prenup are financially independent; if not, the agreement should at least provide the poorer spouse with sufficient resources to meet his or her basic needs.

Also, a prenup doesn't prevent one spouse from sharing the other spouse's wealth if the marriage is a success. Many agreements are designed to provide the poorer spouse with a share of the wealthier spouse's assets that increases in proportion to the duration of the marriage.

Even in a "marriage of equals," a prenup can provide important advantages. In addition to ensuring that the terms of your will are respected, a prenup can protect your assets against your spouse's creditors (and vice versa) by clearly defining each spouse's separate property.

> *Having a prenup doesn't cause divorce any more than buying auto insurance causes you to have a car accident.*

Finally, there are many situations in which a prenup can be used to *enhance* your spouse's wealth, rather than limit it. For example, if a couple agrees that one spouse will raise the children, a prenup can assure that the stay-at-home spouse will receive a greater portion of the couple's wealth than the divorce laws would provide.

Plan carefully

A prenup can help you achieve a variety of financial and estate planning goals and add an element of certainty to your plans. To be effective, the agreement's terms must be carefully drafted in compliance with applicable state law. And to ensure that the agreement can withstand a challenge on grounds of undue influence, mistake or fraud, it should be prepared well in advance of the wedding day and each party should have separate legal representation. ▮

Already married? A *post*nuptial agreement may be the answer

If you didn't draft a prenuptial agreement before you were married, you still have an option: a postnuptial agreement. Many states permit postnuptial agreements, but they require special care. Why? Because courts are particularly watchful for any signs of fraud or undue influence.

Also, keep in mind that, for a contract to be legally binding, each party must provide "consideration." In other words, each party must exchange something of value, such as money, property, services or a promise. With a prenuptial agreement, the marriage itself serves as consideration. But a postnuptial agreement requires additional consideration, such as a mutual release of marital property rights or a transfer of certain property from one spouse to the other.

Income in respect of a decedent

Why some gift horses deserve a hard look

The adage "don't look a gift horse in the mouth" is often applied to inheritances. But for certain types of assets, a thorough inspection may reveal an unexpected tax bite. Most inherited property is tax free to the recipient, but there's an exception for property that's considered income in respect of a decedent (IRD). IRD can be a significant estate planning issue, especially if you have large balances in an IRA or other retirement account — or inherit such assets.

What is IRD?

IRD is income that the deceased was entitled to, but had not yet received, at the time of his or her death. It's included in the deceased's estate for estate tax purposes, but not reported on his or her final income tax return, which includes only income received before death.

To ensure that this income doesn't escape taxation, the tax code provides for it to be taxed when it's distributed to the deceased's beneficiaries. Also, IRD retains the character it would have had in the deceased's hands. For example, if the income would have been long-term capital gain to the deceased, such as uncollected payments on an installment note, it's taxed as such to the beneficiary.

IRD can come from various sources, including:

- Unpaid salary, fees, commissions or bonuses,
- Distributions from traditional IRAs and employer-provided retirement plans,
- Deferred compensation benefits, and
- Accrued but unpaid interest, dividends and rent.

The lethal combination of estate and income taxes (and, in some cases, generation-skipping transfer tax) can quickly shrink an inheritance down to a fraction of its original value.

Planning tips for recipients

If you inherit IRD property, you may be able to minimize the tax impact by taking advantage of the IRD income tax deduction. This frequently overlooked write-off allows you to offset a portion of your IRD with any estate taxes paid by the deceased's estate and attributable to IRD assets. You can deduct this amount on Schedule A of your federal income tax return as a miscellaneous itemized deduction. But unlike other deductions in that category, the IRD deduction isn't subject to the 2%-of-adjusted-gross-income floor.

Keep in mind that the IRD deduction reduces, but doesn't eliminate, IRD. And if the value of the deceased's estate isn't subject to estate tax — because it falls within the estate tax exemption amount ($2 million for 2008), for example — there's no deduction at all.

Calculating the deduction can be complex, especially when there are multiple IRD assets and beneficiaries. Basically, the estate tax attributable to a particular asset is determined by calculating the difference between the tax actually paid by

the deceased's estate and the tax it would have paid had that asset's net value been excluded. For example, suppose you inherited a $1 million IRA and the net value of the deceased's estate was $5 million. The estate tax on $5 million (in 2008) is $1,350,000. If the IRA had been excluded, the estate's net value would have been $4 million and the estate tax would have been $900,000. Your IRD deduction is equal to the difference between the two, or $450,000.

If you receive IRD over a period of years — IRA distributions, for example — the deduction must be spread over the same period. Also, the amount includible in your income is *net* IRD, which means you should subtract any deductions in respect of a decedent (DRD). DRD includes IRD-related expenses you incur — such as interest, investment advisory fees or broker commissions — that the deceased could have deducted had he or she paid them. Thus, to minimize IRD, it's important to keep thorough records of any related expenses.

IRD is income that the deceased was entitled to, but had not yet received, at the time of his or her death.

Planning tips for your estate

IRD can dramatically alter the consequences of your estate plan. Suppose you plan to divide your assets equally among your three children and a charitable organization: One child receives $1 million in real estate, one receives $1 million in publicly traded stocks, one receives $1 million in an IRA and the charity receives $1 million in cash.

On closer examination, it turns out that your children aren't treated equally after all. The real estate and stock are entitled to a stepped-up basis. This means that, when your children sell them, their taxable gain will be based on the assets' value when they inherited them — not on what your basis was. So if they sell the assets as soon as they inherit them, they'll generally owe no tax on the sale. And even if they sell them later and recognize some gain, it may be taxed at the beneficial long-term capital gains rate — perhaps only at 15%. The IRA balance, on the other hand, is IRD subject to income tax at rates as high as 35%.

You can avoid short-changing your third child by leaving him or her the cash and donating the IRA to charity. As an exempt entity, the charity isn't subject to tax on IRD.

Another strategy for dealing with IRD is dividing IRD assets equally among your beneficiaries. Or you can defer the tax by leaving IRD assets to your spouse or to a credit shelter trust for his or her benefit.

A horse of a different color

IRD assets are treated differently than other assets for estate planning purposes. To avoid unpleasant tax surprises, be sure to work with your estate planning advisor to identify IRD assets, assess the tax implications and develop a strategy for eliminating or minimizing IRD.

Could you be taxed in multiple states?

How domicile affects your estate plan

Where you make your home is primarily a lifestyle choice. But it can also have a financial impact, especially if you divide your time among two or more states. Without careful planning, you may find yourself in the unfortunate situation of having multiple states competing for your tax dollars.

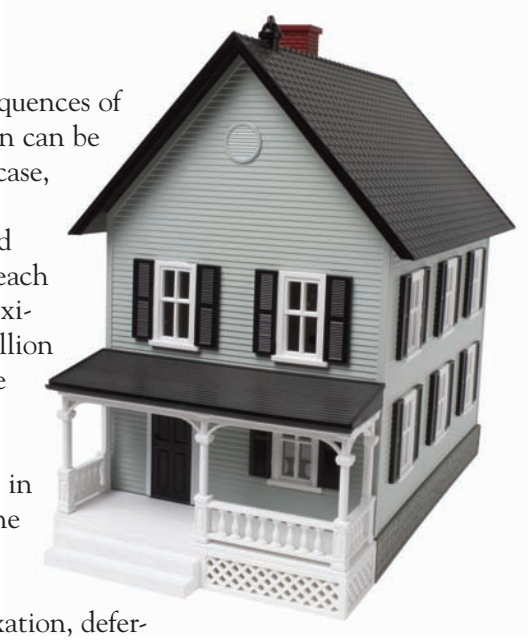
Domicile is where the heart is

Your domicile is your permanent home to which you intend to return whenever absent. When it comes to estate taxes, domicile is a critical factor: Your state of domicile may apply its estate tax to all of your worldwide assets, both tangible and intangible (such as stocks, bonds and other investments).

Real estate and tangible personal property usually also are subject to estate tax in the state where the property is located. Fortunately, the domicile state typically will provide a credit for estate taxes paid to states in which such property is located.

> *If you reside in more than one state, it's important to clearly establish your domicile.*

Technically you can have only one domicile, even if you maintain residences in several states. Because the concept is based on intent, however, determining domicile is subjective. So it's possible for more than one state to claim you as a domiciliary.



The tax consequences of double taxation can be harsh. In one case, *Hill v. Martin*, New Jersey and Pennsylvania each imposed approximately $17 million in taxes on the estate of the deceased, who had residences in both states. The U.S. Supreme Court allowed this double taxation, deferring to each state's determination that the deceased was domiciled there.

Making your intentions clear

If you reside in more than one state, it's important to clearly establish your domicile. Not only will this avoid double taxation of your estate, but, by establishing your domicile in a state with low or no estate taxes, you may be able to reduce or even eliminate state estate tax.

Suppose you divide your time between State A, which imposes a hefty estate tax, and State B, which has no estate tax. If you establish your domicile in State B to the satisfaction of both jurisdictions, you'll avoid state estate taxes except on any real estate or other tangible property you own in State A.

Domicile is based on intent because state taxing authorities can't read your mind. So they determine domicile based on factors that demonstrate your intent, such as the amount of time you spend in a state, the value of your property there, family ties and business activities.

Consider taking these actions to help ensure that your intended domicile is recognized:

- File a declaration of domicile in the state.
- If possible, spend at least 183 days out of the year in the domicile state and keep records of the time you spend in each state or country.
- Use your address in the domicile state as your mailing address as well as on important documents, such as wills, powers of attorney, leases, insurance policies and passports.
- Obtain a driver's license in the domicile state and cancel one from a different state.
- Register your cars, boats or other vehicles in the domicile state.
- Register to vote (and actually vote) in the domicile state.
- Open bank and brokerage accounts and safe deposit boxes in the domicile state and, if possible, close accounts and boxes in other states.
- File resident income tax returns with the domicile state.

Discuss your plans

If you maintain residences in more than one state, be sure to talk with your estate tax advisor about the tax implications of domicile and potential estate tax planning opportunities.

Estate Planning Pitfall

You've designated a minor or legally incompetent person as beneficiary of your life insurance policy

Life insurance is one of the most powerful and flexible estate planning tools available, creating a source of wealth and liquidity to meet a variety of planning objectives. For many people, a life insurance policy is their most valuable asset. But all too often, they neglect to give the beneficiary designation the attention it deserves.

One of the most common mistakes is designating a minor or legally incompetent person as beneficiary. Doing so actually defeats one of the fundamental purposes of estate planning: to have a say in how your wealth is distributed after you're gone.

Insurance companies generally won't pay large sums of money directly to a minor or an incompetent person. So the death benefits won't be available to your family until your executor goes through the time-consuming and expensive process of arranging a court-appointed guardian (who may or may not be the guardian you designated to care for your child).

Even after that happens, however, your estate plan will have little control over how the guardian uses the funds to care for the beneficiary. What's more, in the case of a minor, your beneficiary will gain unrestricted access to the funds as soon as he or she reaches the age of majority.

A better approach is to designate one or more trusts as beneficiaries of the policy. This strategy gives you the flexibility to establish detailed criteria for how and when the funds will be distributed to or on behalf of your loved ones.

You can instruct the trustee to distribute the funds at any age or ages you wish, extending well into adulthood. You also can limit distributions to certain purposes, such as education or health care, or condition them on the achievement of certain milestones, such as graduating from college or remaining gainfully employed.

For a beneficiary who is severely disabled or otherwise legally incompetent, consider establishing a special needs trust, which provides for his or her comfort without jeopardizing eligibility for government assistance.

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Comprehensive Estate Planning Services

Founded in 1960, Weinstock, Manion, Reisman, Shore & Neumann offers estate planning, probate and trust administration, general business and corporate law, taxation, real estate and litigation services. Because 13 of our 15 attorneys are actively involved in estate planning, we specialize in helping clients meet objectives like these:

- Dispose of assets in a tax-efficient manner by using revocable living trusts.
- Minimize estate taxes by using sophisticated lifetime giving techniques, such as Grantor Retained Interest Trusts and Charitable Remainder Trusts.
- Provide liquidity and save estate taxes by using life insurance and irrevocable life insurance trusts.
- Efficiently administer probate and trust estates.
- Transfer business interests to younger family members in a tax-efficient manner.
- Minimize generation-skipping transfer tax on transfers to grandchildren and great-grandchildren.
- Implement deferred compensation and qualified retirement plans, including pension and profit sharing plans.
- Reduce income and estate taxes on the receipt of benefits from retirement plans.
- Avoid court intervention if disability strikes.
- Maximize employee productivity through the use of stock options and other incentive programs.
- Dispose of business interests among co-owners.
- Save on income taxes, both now and in the future.
- Select and form business entities, such as corporations, limited liability companies and family limited partnerships.
- Protect the interests of beneficiaries or fiduciaries in estate, trust or conservatorship matters.

The professionals at Weinstock, Manion Reisman, Shore and Neumann bring over 250 years of combined experience to the services we provide. The stability of our firm enables our lawyers to work closely together with business specialists to give clients outstanding individualized attention.

Many of our lawyers are instructors at UCLA Extension and highly sought after as speakers for professional organizations in the community. Because we are at the forefront of current developments in law, we excel in designing strategies which help clients balance their business and financial interests with their personal and professional objectives in order to preserve and transfer their wealth.