Can estate planners add value to prenuptial agreements?

By Jeffrey A. Baskies

Should estate planners be more involved in drafting prenups? Because prenuptial agreements can fix rights not only on divorce but also at death, and because they may have significant and complex tax issues, more involvement from trusts and estates attorneys in preparing these arrangements could be helpful. Indeed, I would guess that more prenuptial agreements have actually impacted rights at death then at divorce, as it seems logical that more clients who create prenuptials die while still married then see their agreements come into play in a divorce. And if the majority of prenuptial agreements are intact until a client's death, that gives further support to the theory that trusts and estates attorneys should be more involved in their drafting.

It would be interesting to see what percentage of prenuptial agreements are drafted by attorneys who are primarily family/divorce lawyers, what percent are drafted by attorneys who are primarily trusts and estates lawyers, and what percent are drafted either by a lawyer with expertise in both areas or by two attorneys (one from each specialty) in collaboration. I'd also like to learn how often the primary drafter consults with an expert in the other area of specialization.

Key tax issues

Some of the key tax aspects of prenuptial agreement planning are fairly easy. For example, alimony payments are generally deductible for the payor and taxable to the payee. Property settlements, on the other hand, are generally not deductible and not taxable.

However, there are other relevant tax issues. For example, there are issues regarding tax "benefits" relating to minor children. While these are often resolved in divorce agreements, as opposed to prenuptial agreements, they can be addressed in a prenup. Such issues can include which parent can claim an exemption for a minor, deductions for dependent medical expenses and certain child-related tax credits.

In addition, when contemplating property transfers between spouses in case of a future divorce, there are some tax issues to consider. For example, if appreciated or encumbered property might be transferred incident to a divorce, there are capital gains tax issues. Transfers between spouses or former spouses incident to divorce are generally treated like gifts, providing for non-recognition of gain by the transferor and a "carry-over basis" for the transferee. Obviously, this can impact the value of property in the hands of the transferee, and the built-in gain should be considered when valuing the property.

Further, if the property is encumbered by debt, there is no recognition of gain if the transfer is outright to the spouse or former spouse. However, if the transfer is to a trust for the spouse, rather than directly, and the liabilities exceed the basis of the transferring spouse, then the transferor recognizes gain of the excess of the liability over his/her adjusted basis. Therefore, in prenuptial planning there may be a tax trap if part of the funds transferred at divorce will pass into a trust.

There can also be overlapping tax, estate planning and family law issues when dealing with pensions and IRAs. These include how to value those assets, how to segregate them (if a Qualified Domestic Relations Order might be needed) and how to take the distributions on a tax-favored basis (which may make a huge difference depending on the spouses' ages).

Some estate planning issues

There can also be opportunities in prenuptial agreements to deal with several key estate planning issues. For example, a prenuptial agreement may include complex planning for intra-spousal and/or intra-family planning, especially in situations with children from other relationships.

As a starting point, the drafter should be familiar with whatever the state "background" estate planning rules will be, in order to properly advise a client how to alter or draft around them. A key issue will be what rights a surviving spouse would have under state law. Naturally these will vary from state to state, but they might include: intestacy rights, community property rights, elective share rights, pretermitted spouse rights, exempt property rights (in real or personal property) and state allowances of various sorts.

Many prenuptial agreements will waive all of the background state rights and replace them with defined rights at death. These might include outright transfers from one spouse to another, or they might include transfers in trusts. Trusts and estates issues can be implicated by these decisions: for example, if trusts will be used, the federal estate tax exemption (currently $2 million) for each spouse must be considered. Further, there must be consideration of how a trust may be drafted to qualify for a marital deduction.

In addition to tax and succession planning, the prenuptial agreement might also address fiduciary issues. For example, if your client becomes incapacitated, would she want her husband to serve as her guardian (of her person and/or property)? The answer to that question might change depending upon the length of the marriage. And who does your client want to serve as the executor of her estate or trustee of a trust for her benefit?

Finally, there can also be issues regarding the share of the estate passing to children, either of this marriage or from prior marriages. These matters can be addressed in a prenuptial agreement, which could avoid fighting in the future.

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