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Prenuptial Agreements

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Preuptial Agreements

What is it?

Definition

A prenuptial agreement (also known as a premarital agreement, antemarital agreement, or prenup) is a binding contract executed by prospective spouses to define the rights, duties, and obligations of the parties during marriage and in the event of legal separation, annulment, divorce, or death.

What issues are addressed in a prenuptial agreement?

A prenuptial agreement should include you and your spouse's decisions in four basic areas:

- Assets and liabilities--What assets are you each bringing into the marriage? How much are they worth? Who owns them? Which ones will become marital property and which ones will continue to be owned by you or your future spouse individually? Will gifts and inheritances be shared or kept separate? What liabilities do you each have, such as back taxes or other debt?
- Divorce--Will there be alimony or a lump-sum payment? Will you divide or exempt appreciation of assets brought to the marriage? How will you divide assets purchased from joint funds?
- Estates--What will go to children from a previous marriage or children you may have in the future? Who gets what after either spouse dies?
- The contributions of each partner--How will you compensate for special contributions, such as one spouse limiting a career or losing pension benefits due to childrearing responsibilities? How will you compensate for one spouse bringing in more liabilities to the marriage?

When can it be used?

Draw up a prenuptial agreement before you get married

Financial planners generally recommend that couples consider entering into a prenuptial agreement before marriage if they have substantial assets (especially if there is an imbalance in their assets), if one or both may inherit substantial assets, or if they have children from previous marriages. Small-business owners and the elderly are also strong candidates for prenuptial agreements, as well as couples in which one spouse will be supporting the other spouse through professional school (e.g., law or medical) so that the supporting spouse will share fairly in the professional's future income.

If the prospective spouses are young and have comparable net worths, an agreement may provide little benefit. As a precaution, however, most couples should at least discuss the issue with a financial advisor before getting married.

Strengths

Protects your premarital property

If you combine your assets with those of your spouse after you get married, you risk losing them in the event of divorce. To preserve your premarital property, keep all of your assets in your own name after you are married and designate ownership of your property in a prenuptial agreement. Keep in mind that joint ownership can make your assets marital property, which is subject to a property settlement.

Enables you to provide for your family members

A prenuptial agreement can give you the security of knowing that your loved ones will be provided for in the manner in which you intend. If you have children and decide to remarry, such an agreement can ease the fears of your children over how your estate is going to be divided.

A trust is a particularly useful tool in remarriage when you want to provide for your spouse after you die, but make sure your money ultimately goes to your own children, not your spouse's children. When used in conjunction with a prenuptial agreement, a trust eliminates or greatly reduces the possibility of a challenge by your spouse or other heirs, reduces legal costs, and avoids scrutiny by the court.

Reduces or avoids litigation costs

Considerable amounts of money can be lost by both spouses when divorce proceedings turn into a long, messy battle. By explicitly stating how property should be divided in the event of divorce, however, both sides can greatly reduce the fees charged by attorneys, expert witnesses, and appraisers. A prenuptial agreement can also reduce litigation costs associated with contesting the will of a deceased spouse.

Caution: Litigation costs may be a factor, however, if there is a breach of contract claim associated with the prenuptial agreement during divorce proceedings.

Offers you protection against your future spouse's creditors

If your future spouse incurred substantial debt prior to marriage, you may wish to protect your assets from his/her creditors. This can be accomplished in a prenuptial agreement by having your future spouse waive any claims to your assets, except in the event of divorce or death.

Another option is to set up a trust in conjunction with a prenuptial agreement. Assets placed in the trust prior to your marriage would not be owned jointly with your spouse and could not be considered marital property. Your spouse's creditors would therefore have no claim on your assets, but your own creditors might be able to go after them.

Enables you to protect your business assets

In cases where a business is owned by a small number of parties (e.g., a closely held business or a partnership), the owners may wish to prevent a spouse from obtaining voting rights or claims against the business. In such cases, the owners can enter into an agreement that requires each, in the event that they marry, to execute a prenuptial agreement in which the prospective spouse waives all rights to the owner-spouse's interest in the business in the event of divorce or death.

The co-owners may also wish to enter into a buy-sell agreement, whereupon the death of a shareholder or partner, the remaining owners would be required or given the first option to purchase the decedent's interest in the business for a specified amount over a specified period of time.

Tradeoffs

Prenuptial agreements can become outdated

What was fair the day you got married could be completely unfair a few years later. The birth of children that requires one spouse to leave work, or a move that is advantageous to one spouse and detrimental to the other, are examples of changes that could affect the fairness of the agreement. Once the balance shifts, a judge is likely to void the contract, and his or her determination of fairness--not yours--will prevail.

The good news is that, like any legal contract, a prenuptial agreement can be amended or modified to meet your or your spouse's needs as conditions change during the marriage.

Tip: As a precaution, review and update your prenuptial agreement every few years or following

significant events such as a change in economic circumstances or the birth of children.

Relationships between your future spouse or family members may be damaged

Prenuptial agreements are far less likely to damage relationships between couples and their families when they are negotiated for people who have been previously married and who have children from previous marriages. In these cases, each party has loyalties to third parties--usually their children--and each has a legitimate interest in protecting the rights of their children to inherit his or her estate.

A more difficult situation can arise when a prenuptial agreement is negotiated between two people who have never been married before and have no children or third parties they are obligated to support. In such cases, the agreement is often negotiated at the suggestion of the parents, whose concern may be to minimize any financial risk incurred by their child as a result of his or her marriage. In this case, a family's suggestion to create an agreement could be construed as hostility or distrust.

Prenuptial agreements aren't cheap

A lawyer might charge you \$750 for a simple prenuptial agreement, but the majority of agreements are fairly complex and cost between \$3,000 and \$5,000.

Tip: The price may be worth it, since a contested divorce could be far more costly, both in legal fees and emotional strain.

How to do it

Allow plenty of time between the signing of the prenuptial agreement and the wedding

In order for a prenuptial agreement to be valid, it should be written only after you and your future spouse have had enough time to negotiate satisfactory terms. In other words, the longer the time between the signing of the agreement and your wedding, the better. If you wait until the night before the wedding to give your future spouse a prenuptial agreement to sign, it probably won't be considered valid later on, should it be contested. Time may also be needed to properly value assets such as a small business.

Obtain independent counsel

Although there is no requirement that you and your spouse be represented by separate attorneys when drafting a prenuptial agreement, both parties must be offered the opportunity to retain independent counsel. Be aware, too, that a judge may scrutinize the agreement more carefully when one attorney represents both parties. Both you and your prospective spouse should therefore have your own lawyers: If your attorney handles everything for both you and your prospective spouse, a court will probably rule that your spouse was not adequately represented, and the prenuptial agreement will be disregarded.

Prenuptial agreements drawn up without an attorney's help may or may not hold up in court. However, certain variables within a prenup that an attorney would know to look out for could be overlooked by a couple drawing up an agreement alone.

Provide full and accurate disclosure of financial information

The key to a solid prenuptial agreement is full and fair disclosure of you and your future spouse's income, assets, and liabilities. By presenting an accurate snapshot of your respective financial positions before you are married, you will both be able to track the asset gain or loss and come to a fair decision in the event of divorce.

Caution: If you are getting divorced and your spouse uncovers assets that you did not declare in your prenuptial agreement, a court may not uphold the contract. For this reason, lawyers often advise wealthy clients to overestimate their net worth rather than minimize it when drawing up a prenuptial agreement. Usually, both prospective spouses will exchange financial statements listing all assets and sources of income. This information can be obtained from sources such as bank statements, cancelled checks and old check registers, savings account passbooks, income tax

returns (both personal and business), estate and gift tax returns, financial reports, loan applications, and income and balance sheets for a business. Both parties must also be thorough about disclosing any debts and financial obligations, including child support, alimony, or back taxes.

Make sure the agreement is free of any hint of duress

The court is likely to throw out any agreement that it determines was made under emotional stress, physical or mental disability, or threat of force. Many lawyers will videotape the signing of the agreement to show that both sides were fully aware of what they were doing and acted of their own free will.

Example(s): Amusement park developer Ronald Bump has decided to marry his girlfriend Darla, an aspiring acrobat. Having lost a substantial portion of his multimillion-dollar fortune to his first wife, Imelda, however, Ronald has a prenuptial agreement drawn up that would allow him to hold on to his remaining assets if his marriage to Darla fails. Although she is deeply in love with Ronald, Darla feels pressured and is uncertain about signing the agreement. "Why would Ronald do this to me two weeks before our wedding?" she asks Bumpy the Clown. "After all," she rationalizes, "he left Imelda to be with me--and our twins are due in less than a month!" Bumpy tells her that Ronald probably wants to make sure that she and the babies are properly taken care of in the event of his death, and Darla reluctantly signs the agreement two days before marrying Ronald at the Bumptown U.S.A. theme park.

Example(s): Fast forward two years: Ronald and Darla's prenuptial agreement is thrown out during divorce proceedings after the judge decides that Darla signed the agreement under duress.

Be fair

If your spouse is dependent on you financially, the provisions of your prenuptial agreement cannot leave him or her destitute in the event of divorce. It is against the law for the court to violate public policy (i.e., place your spouse on public assistance), and a judge will likely rule against you.

The fairness of an agreement, however, varies from state to state. Although several states have adopted the Uniform Premarital Agreement Act's requirement that a prenuptial agreement not be unconscionable at the time it was executed, other courts have held that the agreement must be fair at the time of divorce. Some states require that it be fair both at the time of execution and at the time of divorce. Determining whether an agreement is unconscionable is based on the circumstances and facts of each case, as certain provisions are more likely than others to be considered unconscionable. In the case of death, most states include a provision in their probate laws preventing one spouse from completely disinheriting the surviving spouse. These laws generally give the surviving spouse the right to elect against what was provided in the will and instead take a set percentage of the deceased spouse's assets. Nevertheless, prenuptial agreements in which a surviving spouse gives up his or her right to an elective share have been deemed enforceable. To ensure that the terms of the agreement will be enforced, the agreement should state that the new spouse agrees to waive all claims against specific assets and instead agrees to satisfy any marital property rights only with other assets in the event of divorce or death.

Distinguish between marital property and separate property

A prenuptial agreement should clearly differentiate between marital property and separate property. Marital property generally includes all assets that were acquired by either or both spouses during the marriage. Separate property falls into three categories: what you bring into the marriage, what you inherit during the marriage, and what you receive during the marriage as a gift. Be sure to familiarize yourself with the laws of your state pertaining to separate property and marital property, since different states have different definitions of what constitutes one or the other.

If you want to keep your assets separate when you marry, a trust is an excellent option. If the trust is set up in conjunction with a prenuptial agreement, assets placed in the trust are owned by the trust and are not considered marital property during the marriage, even in community property states.

Caution: If you set up a trust without a prenuptial agreement, you may have little or no protection, since a court could consider assets in the trust marital property subject to division. Your spouse's signature on a prenuptial agreement would prove that you did not use the trust to fraudulently

transfer your assets out of your spouse's reach.

Consider including a "triggering event" within the agreement

When included in a prenuptial agreement, a triggering event (e.g., the sending of a registered letter) could be used to automatically initiate divorce proceedings. It would also distinguish between marital property and separate property as of the date of the event. Such a strategy could work to your advantage, especially if your agreement is based on providing your spouse with a percentage of your wealth and you are anticipating future earnings or an inheritance.

Tax considerations

Income tax

Executing a prenuptial agreement does not usually result in any immediate tax consequences. Tax consequences do arise, however, after one of two events--divorce or death--activates the terms of the contract. To properly plan for your desired tax consequences, you should be aware of the tax ramifications of all property transfers you made before signing the agreement. These not only include transfers made upon divorce or the death of you or your spouse but also transfers made at the time the agreement is executed and during marriage. For more information, see our separate topic discussion, *Tax Issues Related to Marriage*.

Tip: Since tax laws are constantly changing, you should have your agreement examined periodically to ensure that it accurately reflects the wishes of you and your spouse.

Clarify tax responsibilities within the agreement

A prenuptial agreement should clarify who will pay to defend a tax audit, if necessary, as well as who will pay any assessed taxes, interest, and penalties. Some agreements stipulate that the couple will file as married filing separately so that the tax problems of one spouse will not affect the other--even though the couple will end up paying more taxes that way.

Tip: Even when spouses file their taxes as married filing jointly, one spouse may be protected against the actions of the other under innocent spouse rules, which were revised by the IRS Restructuring and Reform Act of 1998. Under these rules, although each spouse who signs a joint return is fully responsible for the accuracy of the return as well as the payment of tax, if one spouse failed to report income or reported deductions or other items improperly, the other spouse can sometimes be relieved of the tax, interest, and penalties related to these items.

Filing joint tax returns

If you choose to file as married filing jointly, both you and your spouse should be entitled to receive copies of the return and supporting documents each year. By doing so, you will avoid future problems in the event of divorce negotiations, if either you or your spouse cannot access necessary tax records.

Gift tax

Generally, property transfers made before marriage may have adverse gift tax consequences, whereas transfers made during marriage are not subject to gift or income tax. When drawing up a prenuptial agreement, therefore, you should stipulate that any transfer of property occur after the wedding.

Example(s): Ken and Sue have decided to get married. Ken owns a substantial share in Icy Frozen Foods that he wants to hold on to if the marriage doesn't work out. He and Sue decide to draw up a prenuptial agreement that provides for Ken to transfer \$250,000 to Sue in exchange for her release of all marital claims against any of Ken's property in the event of divorce. A month before the wedding, Ken transfers stock worth \$250,000 to Sue. Ken had purchased the stock several years ago for \$50,000. The transfer of the stock causes Ken to have a taxable gain for income tax purposes of \$200,000. In addition, Ken has made a gift (subject to the gift tax rules) of \$250,000, and Sue's basis in the stock is \$250,000.

Example(s): If the transfer of the stock had occurred after the wedding, Ken would not have recognized gain on the transfer, since property transfers between spouses do not result in recognition of gain or loss. He would have also avoided the gift tax because of the unlimited marital deduction for gifts between spouses.

Estate tax

When a prenuptial agreement takes effect due to the death of a spouse, assets passing from the deceased spouse to the surviving spouse under the terms of the agreement may qualify for the estate tax marital deduction. The deduction cannot exceed the value of the adjusted gross estate, however, and only certain assets qualify for it. For a complete list of property that qualifies for the estate tax marital deduction, see Schedule M (Bequests, etc., to Surviving Spouse) of Form 706.

Questions & Answers

Does a prenuptial agreement mean that the prospective spouses don't trust each other?

Perhaps, but a prenuptial agreement is generally grounded in realism rather than a lack of trust. For instance, an older couple marrying for the second time may simply want to protect the inheritances of their children. Some younger couples, on the other hand, might feel that they will save money in the future if the marriage doesn't work out.

Can a domestic partner agreement that you had drawn up when you decided to live together be converted to a prenuptial agreement?

Yes, by following these steps:

Review your domestic partner agreement and make any changes and updates that you have both agreed upon. Rewrite the contract and call it a prenuptial agreement. Be sure to state that the agreement is in contemplation of marriage and does not take effect until you marry. Since there is no good self-help resource for writing a prenuptial agreement, have your agreement reviewed by an attorney. Even a small mistake on your part can invalidate your agreement. Lastly, sign your new agreement in front of a notary.

Is it possible to write an ironclad prenuptial agreement?

Although you may have done everything correctly, you may still find yourself without an ironclad prenuptial agreement. In New York State, for example, anyone who signs a prenuptial agreement has six years from the time the agreement was signed to contest its contents.

Can a prospective spouse waive his or her right to retirement plan benefits in a prenuptial agreement?

In general, if the retirement plan is covered by the Employee Retirement Income Security Act of 1974 (ERISA), an individual can not agree to waive his or her statutory right to benefits under the plan as part of a prenuptial agreement. While ERISA allows a spouse to waive his or her right to plan benefits (for example, a spouse can waive the right to receive a qualified joint and survivor annuity), only an actual spouse (not a prospective spouse) can exercise those waiver rights. In addition, the waiver must comply with specific statutory procedures. However, it may be possible for a prenuptial agreement to provide that the prospective spouse agrees to waive his or her rights once the marriage is consummated. Consult a qualified attorney if protection of retirement plan benefits is important to you.



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