Estate Planning Insights

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WHY PRE-NUPS ARE SMART

Some Reasons For A Pre-Nup. Many people who are about to enter into a second (or third or fourth) marriage (hereafter simply referred to as a "second marriage") avoid bringing up the idea of a Pre-Marital Agreement (sometimes referred to as a "Pre-Nup") with their fiancé before the wedding because they "don't want to hurt his/her feelings." This is very short-sighted. Marriage is an economic and financial arrangement, as well as a romantic, social and spiritual arrangement. Marriage is a form of partnership that involves and affects assets and income.

In addition, many people believe that Pre-Nups are just for the "rich and famous," such as movie stars. Unfortunately, the consequences of *not* having a Pre-Nup can be very, very expensive. Therefore, it is the less wealthy people who will suffer more, on a percentage basis, due to not having a Pre-Nup.

Further, some people may have unrealistic expectations regarding how their second spouse and children will treat each other after they die.

Finally, it is very hard to do estate planning for couples in a second marriage who do not have a Pre-Nup. An estate planning attorney has to know "Who owns what" in order to create an effective estate plan. In a second marriage without a Pre-Nup, the ownership of many of the assets is changing constantly–even daily.

All Marriages End. All marriages terminate, eventually. Some marriages terminate due to divorce. The divorce rate is about 50%. Those marriages that do not terminate due to divorce terminate as a result of the death of the first spouse. The death rate is 100%! We do not do any divorce work. So, when we recommend getting a Pre-Nup prior to entering into a second marriage, we are not giving that advice due to the possibility of the marriage ending in a divorce. Our advice is due to seeing what happens when the first spouse in a second marriage dies and there was no Pre-Nup. Even if no one "contests" (challenges) the ownership of the assets when the first spouse dies, the Executor of the deceased spouse's estate has a fiduciary duty to determine the precise ownership of the assets. This can be a very difficult and expensive process in a second marriage situation where there was no Pre-Nup. In addition, the risk of a lawsuit when the first spouse in a second marriage dies is much higher when there is no Pre-Nup. Unfortunately, it is quite common for disputes to arise between the children of the deceased spouse and the surviving spouse. Usually, the disputes are based on the ownership of the assets.

Separate Property. Per the Texas Constitution and Texas Family Code, a married person living in Texas can own separate property, which consists of:

1. Assets owned by the spouse prior to the marriage *(not commingled to any extent during the marriage).*
2. Assets received by the spouse by gift or inheritance during the marriage (*not commingled to any extent during the marriage*).
3. Most of an award for personal injuries sustained during the marriage--excluding any recovery for lost wages and lost earning capacity during the marriage (*not commingled to any extent during the marriage*).

Note the warning about *commingling.* Commingling is a serious and ubiquitous problem. Many people do not understand how easily separate property becomes commingled under Texas law. We will focus on the commingling problem later in this newsletter.

Community Property. Although not defined in the Texas Constitution or Family Code, community property is all property acquired by either spouse during the marriage *other than* gifts, inheritances and (most of)

a personal injury recovery. Income of every type received during the marriage is community property. This includes (i) compensation of every type paid to both spouses for personal services during the marriage and (ii) the income earned during the marriage by all of the assets, whether those assets are community property or separate property. (Note that the term "property" used in this newsletter is not limited to "real property"–it includes all assets of every type.)

Possible Marital Assets. Married couples in Texas can have the following types of property:

1. Husband's separate property.
2. Husband's sole management community property.
3. Joint management community property.
4. Wife's sole management community property.
5. Wife's separate property.

As indicated, Texas has a type of community property called "sole management community property" (also called "special community property"). This is community property that is titled in just one spouse's name and managed solely by that spouse. Examples include (i) compensation received by that spouse for personal services and (ii) income earned by that spouse's separate property. That compensation and those earnings are community property, owned ½ by each spouse, even though titled solely in just one spouse's name. The named spouse, as manager, owes a fiduciary duty to the other spouse to manage his sole management community property for the benefit of both spouses.

Both a spouse's separate property and a spouse's sole management community property are titled solely in that spouse's name. Thus, in Texas, the title of an asset does NOT tell us the owner of the asset–the most we can tell from the title of an asset is the *manager* of the asset. Texas is not a "title state"!

Community Property Presumption At Death. On the death of the first spouse, all assets on hand are presumed to be community property. This is a legal presumption that can only be overcome by "clear and convincing evidence." *Clear and convincing evidence* means more than a preponderance of the evidence--it is the highest burden of proof in the civil law. Absent clear and convincing evidence otherwise, all assets on hand when the first spouse dies, regardless of how titled, will be treated as community property, owned 50% by each spouse.

Despite the community property presumption, in many second marriage situations where there was no Pre-Nup, the Executor will be at great risk of being sued if the Executor does not determine the actual ownership of each and every asset. It is not unusual for the children of the deceased spouse and the surviving spouse to "disagree" on the marital property characterization of at least some of the assets. And, in fact, in a second marriage where there was no Pre-Nup, there is often clear evidence indicating that some or many of the assets on hand are partly the separate property of one spouse and partly community property.

The community property is severed at death. In Texas, this happens on an asset by asset basis (and not "in the aggregate"). The first spouse to die has the right to dispose of his 50% interest in the community property and 100% of his separate property. On the first spouse's death, the surviving spouse is entitled to keep her 50% interest in the community property and her separate property. Because one spouse may be the sole manager of a community property asset, however, that spouse has the power to leave 100% of his sole management community property to someone other than his wife (i.e., to a "third party"). When the first spouse disposes of the surviving spouse's community property ½ interest in his sole management community property to a "third party," that causes problems for the surviving spouse. The surviving spouse in this situation may be forced to sue the deceased spouse's estate, alleging "fraud on the community," to avoid being treated by the IRS as making a taxable gift of her ½ of that asset to the third party (there is already a tax case on point). Obviously, this is a "no win" situation that should be avoided.

Commingling. One of the biggest benefits of obtaining a Pre-Nup prior to a second marriage is the ability to eliminate the "commingling problem" that will arise during the marriage. As noted above, assets owned prior to marriage are separate property. As also noted above, however, all income during the marriage, *including the income earned by separate property assets,* is community property. Thus, if there is no Pre-Nup to deal with the "commingling" of community property income with separate property assets, once a couple marries, many of their respective separate property assets will start to become commingled and, therefore, will start to become partly separate property and partly community property. Commingling during the marriage primarily happens because of Texas' rule that income earned by separate property during the marriage is community property.

Example. Husband and Wife just got married (second marriage for both). Both are in their late 40s. Both have children from their prior marriages. They did not sign a Pre-Nup prior to their wedding.

The day before the wedding, Husband owned the following assets as his separate property:

1. An IRA rollover from his prior employer worth $1,000,000.
2. A 401(k) plan with his current employer worth $500,000.
3. An after-tax investment account with a brokerage firm holding $1,200,000 in marketable securities.
4. A bank account with $75,000 in it.
5. Tangible personal property (household furnishings, entertainment system, car, clothing, jewelry, guns).

The day before the wedding, Wife owned the following assets as her separate property:

1. A personal residence worth $1 million, subject to a mortgage of $500,000 (15 years left).
2. An IRA worth $150,000.
3. A 401(k) plan worth $300,000.
4. A brokerage account worth $500,000.
5. A bank account with $35,000 in it.
6. Tangible personal property (household furnishings, car, clothing, jewelry, china, silver, art).

The following income was earned during the first year of the marriage:

Interest & dividends of $33,000 inside Husband's IRA.
Interest & dividends of $14,000 inside Husband's 401(k) plan.
Husband's salary of $265,000, of which $24,000 went into his 401(k) plan, equally matched by his employer, and the balance went into a joint checking account.
Dividends of $36,000 earned by the securities in Husband's after-tax brokerage account.
Interest & dividends of $4,000 inside Wife's IRA.
Interest & dividends of $6,500 inside Wife's 401(k) plan.
Wife's salary of $120,000, of which $6,000 went into her 401(k) plan, to which her employer added $4,000, and the balance went into a joint checking account.
Dividends of $9,000 inside Wife's brokerage account.

Upon marriage, Husband moves into Wife's home and the couple opens a joint checking account. Their salaries go into that account. Assume funds from the joint checking account were used to make the mortgage payments on Wife's home. The mortgage payments during the year totaled $48,000, of which $25,000 was interest and $23,000 was principal. Of course, the couple had other expenses, too (living expenses, home maintenance and utilities, entertainment expenses, property taxes, etc.). Assume Husband took $20,000 out of the joint checking account during the year and put it into his after-tax investment account.

At the end of the first year, most of the assets have changed character. (To keep things *really simple*, we will ignore capital appreciation [growth] in the value of the assets during the year.)

1. Husband's IRA is now 96.8% his separate property ($1,000,000 ÷ $1,033,000) and 3.2% community property ($33,000 ÷ $1,033,000).
2. Husband's 401(k) plan is now 89% his separate property ($500,000 ÷ 562,000) and 11% community property ($62,000 ÷ $562,000).
3. Husband's after-tax investment account is now 95.5% his separate property ($1,200,000 ÷ $1,256,000) and 4.5% community property ($56,000 ÷ $1,256,000).
4. Wife still owns 100% of the residence as her separate property due to the "inception of title" rule, but Husband (or his estate) could make a reimbursement claim for the $23,000 in <u>principal</u> payments on the mortgage made with community property. A reimbursement claim is an equitable claim, though, and because Husband was able to live in Wife's home, rent-free, it is doubtful his reimbursement claim would be successful.
5. Wife's IRA is 97.4% her separate property ($150,000 ÷ $154,000) and 2.6% community property ($4,000 ÷ $154,000).
6. Wife's 401(k) plan is 94.8% her separate property ($300,000 ÷ $316,500) and 5.2% community property ($16,500 ÷ $316,500).
7. Wife's brokerage account is 97% her separate property ($300,000 ÷ $309,000) and 3% community property ($9,000 ÷ $309,000).

Of course, the income earned by the assets held in the spouses' respective brokerage accounts (which is community property) can be removed from those accounts and placed in the joint checking account, to keep the brokerage accounts from being commingled. Most people in a second marriage fail to do that, however. Further, some people make the problem worse by "reinvesting" the dividends. Unfortunately, the earnings inside the 401(k) plans and IRAs cannot be withdrawn prior to age 59½ without a penalty.

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Suppose the marriage continues for anther 20-30 years and this type of "commingling" happens each year. Imagine the amount of *tracing* that will be required to determine the separate property and community property portions of each asset.

Terms of Pre-Nup. A Pre-Nup can avoid the commingling problem by providing that *all income earned by a spouse's separate property assets during the marriage will be the separate property of that spouse*. Some couples also provide that compensation for personal services (e.g., salary, bonus, commissions) received by each spouse during the marriage will be that spouse's separate property. While many couples do not want to "go that far," a Pre-Nup could at least provide that salary deferrals (i.e., contributions) during the marriage to a 401(k) plan that started out as the separate property of one spouse will also be considered separate property (so that the 401(k) plan does not become commingled). If both spouses have 401(k) plans, this can be a reasonable provision. In that way, each spouse can own 100% of his/her respective 401(k) plan and can leave that plan on death to his/her children from the prior marriage if he/she so chooses (and the spouse consents). The example in this newsletter was very simple and did not show all of the problems that can arise in a second marriage entered into without a Pre-Nup. Many other "problems" caused by the rules applicable to marriages can be avoided by specific provisions in a Pre-Nup. Note that couples already in a second marriage who did not obtain a Pre-Nup prior to their wedding can obtain a Post-Nup to deal with these issues. Also note that there is nothing about a Pre-Nup or Post-Nup that prevents spouses from making gifts to each other, either during life or at death. Hopefully, the simple example above provides some idea of some of the problems that can arise in a second marriage when there is no Pre-Nup.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above, or by email sent to:

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