The "Stealth Prenup": How Thoughtful Estate Planning Can Avoid the Need for a Prenup for Gifts and Inheritances

by Mark R. Parthemer, Esq.

Abstract: A comprehensive estate plan that includes a stealth prenup in the form of tailored trusts and family investment vehicles may minimize the dissipation of wealth away from the family, provide the entire family peace of mind, and avoid the potential damage to the engaged couple's relationship from having to raise the topic.

Your clients announce to you that their child has found true love. They are overjoyed, or not. Perhaps they are a little unsure it will last; perhaps they are a little unsure they want it to. Regardless, it is clear in their discussion that as they reflect on this family-changing event, they determine to be a good steward of their family's wealth, particularly in light of the alarming divorce rate.

They tell you their friends have pointed out that the current divorce rate in the United States is 41% for first marriages, 60% for second marriages and a stunning 73% for third marriages, with the median duration of first and second marriages less than eight years each. You share that it is no wonder a second (or third) marriage is said to be the triumph of hope over experience!

So, what advice would you give?

Enter from Stage Right: The Prenup

The first thing that springs to mind is a prenuptial agreement ("prenup"). Prenups are the most thought-of form of antenuptial agreement. Postnups are the other, so-called because they are entered into after nuptials are exchanged on the big day. Both are forms of contracts that typically govern property distribution and the waiver of rights thereto, effective at the dissolution of a marriage, whether by divorce or death. In most jurisdictions, however, the agreement must be in writing and each party must have their own attorney and make full disclosure of their assets and expectancies.

Historically, judges were conceptually hesitant to allow prenups because the core of such agreements alters the very essence of marriage. In these more modern times prenups, if done correctly, can be effective and indeed withstand unreasonable attack. One should be careful because although prenups can be established in all states, 41 states are "common law" states (for these purposes, equitable-division states) and nine are community property states. Persons may need specific provision for either, and in some cases in which property may be earned in differing states, both.

Not all evidence suggests prenups require leaps over high hurdles to make them enforceable. The *Wall Street Journal*, in its magazine *Smart Money*, once recounted the story about San Francisco Giant baseball player Barry Bonds. According to the report, when Mr. Bonds' first marriage dissolved in 1994, his then wife, Susann Margareth Branco of Sweden, failed to convince a California court to ignore their prenup (it waived her right to his multimillion dollar earnings).[1] She claimed that (1) she was forced to sign it on the way to the airport as they were on their way to Las Vegas to be married, (2) it was in English—not her first language, and (3) she did not have a chance to consult with her attorney. The court determined the prenup to be valid and enforceable. (One result was the subsequent passage in California of a law prohibiting 11th-hour prenups, and similar legislation has thereafter been adopted in many states.)

The point is not to suggest whether a prenup is prudent or whether one may be legally binding. Frankly, prenups and postnups work. However, we all recognize that discussions of such matters are awkward at best, especially for a young couple. The result is that often the process remains incomplete or, if completed, leaves a lingering bad taste—the mere act of raising the subject of a prenup rings a bell that cannot be unrung. In addition, even if one is signed, there remains the risk of the prenup being contested years later.

For an article published in *New York* magazine, Donald Trump, having twice succeeded in having the prenups

with his first two wives upheld, credited the value of having one but acknowledged they can be difficult to discuss. Referring to a prenup, he said, "It's a hard, painful, ugly tool. Believe me, there is nothing fun about it."[2]

So, do you have any options to provide your clients? Well, we have seen this one many times. One of my favorite alternatives is what I call a "stealth prenup." Ironically, a stealth prenup is not a prenup at all, but rather a thoughtful use of trusts and family investment vehicles, such as limited partnerships or LLCs. Generally, it is the structuring of how wealth is owned and transferred down a generation, whether by gift or inheritance. Thus, most frequently, this strategy simply and effectively can be embodied in the senior generation's estate planning.

The Law—Equitable Distribution of Marital Assets

In most states, distribution of marital assets upon termination of a marriage is governed by equitable distribution. Thus, such assets are divided equally between the spouses (though a judge may make adjustments).

Nonmarital assets are not divided between the parties. These include assets acquired prior to the marriage and assets received by gift and bequest before or during the marriage (and assets acquired in exchange for them).

That is good news, but not the end of the story. It matters what one does with nonmarital assets. Are they used to make a purchase, such as a home, or deposited in a bank or brokerage account, which is titled jointly with the spouse as tenants by entireties? Some states have laws creating a presumption that such assets have been converted to marital assets.

What about if one partner brings a house to the marriage? She may keep the property in her name to preserve it as a nonmarital asset, but a claim against it may ensue if marital assets are used to make mortgage payments (e.g., such as money from a joint account). And if her husband helps makes repairs or improvements, he may be entitled to a prorated portion of any appreciation.

In addition, the law often provides that increase in value of nonmarital assets is deemed marital property. For example, let us assume a child receives a gift of $100,000 in investments and preserves the gift as nonmarital property by keeping the assets solely in his/her name and never converting them. Yet, if a divorce were to occur years later after the account had grown to $250,000, the original $100,000 may be safe, but the $150,000 of growth could be deemed marital property and split 50/50 between the child and his/her divorcing spouse.

A Twofold Solution

Part 1: Discretionary Trusts

The most common form of a stealth prenup is a thoughtfully structured trust that parents or grandparents set up during life or through their wills, revocable trusts, or other estate planning documents. The result is that the wealth they wish to protect ultimately passes into trust, where it, and its future growth in value, is held for the child's benefit.

For maximum effect, the trust distribution provisions should be discretionary—that is, the trustee has discretion whether to distribute income and principal. Frequently, I see trusts that have a mandatory distribution, such as requiring income to be distributed annually, distributed at specified ages, or perhaps discretionary but subject to a standard, such as distributing for a beneficiary's health, education, maintenance, and support. These may prove problematic. Mandatory standards create in the beneficiary enforceable rights to the distributions, and what a beneficiary may demand, so may the beneficiary's creditors.

Remember that the court can deviate from an equal division of assets. One factor is the economic circumstances of the parties. If a child has the right to trust income or can compel the trustee to distribute trust assets, a court may be more likely to find that that justifies giving the child's spouse more than 50% of the marital assets. (It also may affect the amount and extent of alimony, which is beyond the scope of this article.)

It is important to ensure that the family's capital stays in the trust. Often, trusts are drafted to mandate direct distributions of portions of trust principal at various ages between 25 and 40. This is fine, but as the ages are attained, the trustee must make the distributions. Once the assets are in the beneficiary's hands, they are subject to the above rules and thus may be converted to marital assets. Therefore, parents and grandparents should consider continuing such a trust, perhaps for the lifetime of the child.

Part 2: Family Investment Vehicles

The other most common form of a stealth prenup is the family investment vehicle (FIV), usually in the form of a limited partnership or an LLC. An FIV may be funded with publicly traded

stocks or bonds, real estate, or private equity holdings, including ownership interests in a family business. This form of planning typically enables family members to invest together in asset classes that the individual members otherwise might not be able to utilize or access. Also, an FIV can provide for common management, restrictions on transferability outside the family line, and ease of transfer to permitted recipients without fractionalizing the underlying asset.

More important for the topic at hand, FIVs can serve to control access to assets in two critical ways: the owner cannot demand access to the underlying assets nor can he/she sell/transfer the ownership interest to a third party. This latter point includes divorcing spouses as third parties. So, limiting a child's right to distributions and ability to transfer ownership should limit the extent to which the court considers these assets when dividing marital assets (and setting alimony). Interestingly, even if the value is included in determining distribution, the prohibition should avoid the interest itself from being used to satisfy the distribution (this would avoid or minimize the dissipation of family assets outside the bloodline).

Further, if a child receives interests in an FIV as nonmarital property, embedded transfer restrictions may protect the interests (and the assets in the entity) from possibly being converted to marital assets. The same benefits may be achieved if, before marriage, the child contributes his or her assets to an FIV.

In short, a comprehensive estate plan that includes a stealth prenup in the form of tailored trusts and FIVs may minimize the dissipation of wealth away from the family, provide the entire family peace of mind, and avoid the potential damage to the engaged couple's relationship from having to raise the topic. ■

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(1) Aleksandra Todorova, "When Prenups Fail," *Smart Money* (December 7, 2006).
(2) Geoffrey Gray, "With This Ring (and This Contract), I Thee Wed," *New York Magazine* (March 19, 2006).