



# ESTATE PLANNING INSIGHTS

## STRATEGIES TO PROTECT YOUR FAMILY & YOUR WEALTH

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If you would like further information about any of the topics discussed in this newsletter, please contact the following member of our Trusts & Estates Department:



**Craig D. Solar**  
Tel: (914) 993-6049  
Fax: (914) 993-6016  
[csolar@kelaw.com](mailto:csolar@kelaw.com)

“There are two systems of taxation in our country: one for the informed and one for the uninformed.”  
*Honorable Learned Hand,  
US Appeals Court Justice*

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**Kurzman Eisenberg Corbin & Lever, LLP**

One North Broadway  
White Plains, NY 10601  
[www.kelaw.com](http://www.kelaw.com)

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# 4 common misconceptions about prenuptial agreements

**W**

hen 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, including New York, 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 com-

plete financial inventory, there's a risk that it can be challenged on the grounds that one spouse didn't fully understand what he or she was agreeing to.

Even if you and your fiancé 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 spouse's 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. If both parties to a prenup are not financially independent, the agreement should at least provide the poorer spouse with sufficient resources to meet his or her basic needs.

Also, a prenuptial agreement doesn't prevent one spouse from sharing the other spouse's wealth if the marriage is a success. There are many situations in which a prenup can be used to enhance your spouse's wealth.

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 otherwise provide. Also, in some agreements, the poorer

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

spouse's share of the wealthier spouse's assets 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.

#### 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 postnuptial 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.

# Plan ahead for peace of mind

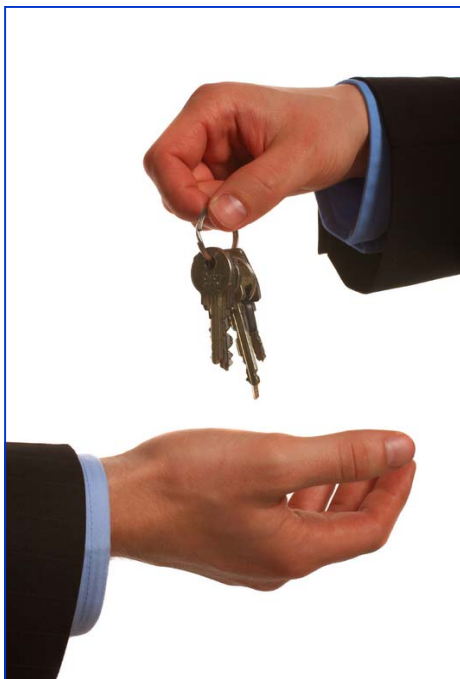
## The benefits of using a buy-sell agreement

**I**f you are an owner of a closely held business, consider creating a buy-sell agreement. It provides the means for an orderly transfer of ownership at your death, whether to family members or to remaining owners.

It also can establish what will happen to your interest in the events of other triggering events, such as disability, retirement, withdrawal or other specified events. Moreover, it details the terms of the future sale — such as who will have the obligation or option to buy out your interest and how the sale price will be established.

### Buy-sell agreement objectives

A buy-sell agreement sets a value for your ownership interest (generally based on an independent appraisal of your business or an appropriate valuation formula) and provides a market for the interest. It can also help set the value of the interest for federal estate tax purposes, which reduces the likelihood of challenges by the IRS. (See “Determining value” on page 4 for more on valuation methods.)



### Two types of agreements

The two basic types of buy-sell agreements — cross purchase and redemption — are typically funded by life insurance. Using life insurance helps ensure that your business partners will have adequate liquidity to cover the full buyout of your ownership interest. This, in turn, provides your heirs and your estate with liquidity that might otherwise be lacking if there were no ready cash for your ownership interest.

Let’s take a look at each agreement type:

**Cross purchase agreement.** With this agreement, each owner owns life insurance policies on the other owners’ lives. When an owner dies, the surviving owners buy his or her interest.

Cross purchase agreements can offer several tax advantages. For example, the surviving owners receive a stepped-up basis equal to the purchase price, which reduces income taxes in the event they later sell their shares. Also, because the insurance proceeds bypass the company, the surviving owners avoid corporate alternative minimum tax (AMT) issues.

On the down side, the agreement can be tedious when there are more than a few owners. Why? Because the number of insurance policies required expand so quickly. For example, a company with three owners would require six policies, but a company with double the owners (6x) would require five times as many policies (30).

This issue can be avoided by using a trustee cross purchase agreement, whereby the trustee is the owner and beneficiary of one policy on each owner. The trustee is required to fulfill the obligations under the agreement.

There can also be issues with how premiums will be paid — especially if there are signifi-

cant age differences between the owners. In such a situation, the premiums on the policies for the older owners likely will be much higher.

**Redemption agreement.** In this agreement, the company owns the life insurance policies on the owners' lives. After the owner dies, the company buys back that owner's shares. Since the company is the sole policy owner, if there are more than two owners fewer policies are needed and the payment of premiums is simpler than with a cross purchase agreement.

A redemption agreement may be easier to administer than a cross purchase agreement, but it also can create tax problems. Remaining owners do not receive a stepped-up basis, and if the company is a C corporation it may be subject to corporate AMT on the life insurance proceeds.

In certain situations, combining elements from both a cross purchase agreement and a redemption agreement to create a hybrid agreement may be the ideal solution for all involved parties.

## Tailoring the agreement

There's no "one-size-fits-all" buy-sell agreement; it must be customized to meet your company's and its owners' needs. Specifically, the agreement should:

- Stipulate the triggering events for the sale of an owner's interest in the company,
- Set a method for valuation, and
- Outline the purchase price for the owner's interest and determine funding.

Regularly review the buy-sell agreement to ensure it meets all requirements and tax laws, as well as the evolving needs of your business.

## Plan for your heirs' future

A buy-sell agreement can ensure the value of your business interest transfers according to your wishes. By making preparations today, you can help alleviate potential discomfort between the company's remaining owners and members of your family — and also help contribute to your heirs' financial well being. ■

## Determining value

There are several methods for valuing a business interest when drafting a buy-sell agreement, such as:

**Formula pricing.** This method provides a means to estimate fair market value. Formulas are objective but sometimes they may not consider factors that influence fair market value. When using a formula price, regularly review it to ensure that it remains in line with your objectives.

**Book value.** This is the net book value determined by the entity's records or tax returns or as determined under Generally Accepted Accounting Principles (GAAP). This value may be based on your company's financial statements, audit or tax return. Net book value is not typically indicative of fair market value.

**Certificate of agreed value.** Sometimes the purchase price of an interest in a closely held company is based on an amount agreed on by the owners (which often is predicated on the amount of an owner's life insurance policy proceeds) or by an independent appraiser. This method may be simple, but it is important to periodically update the certificate of agreed value.

The method you choose can affect whether the value will apply for estate tax purposes. After you've determined which method is best for you, be sure to periodically review and update it as needed.

# Could you be taxed in multiple states?

## How domicile affects your estate plan

**W**here 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. However, since the concept is based on intent, 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 es-

tate 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. It may even be possible to avoid State A's estate tax on the real estate you own in State A if such real estate is owned by you through an LLC.

Domicile is based on intent. Since state taxing authorities can't read your mind, 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 if your state allows one to be filed.
- Move your important personal possessions to the domicile state.

- 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.

### **Making your intentions clear**

If you maintain residences in more than one state, be sure to take the proper steps to ensure that your intended domicile is recognized. Talk with your estate tax advisor about the tax implications of domicile and potential estate tax planning opportunities. ■

# Estate Planning

## Pitfall



### **Your will or trust doesn't name contingent beneficiaries**

Estate planning is difficult because it forces you to plan for your own death. To plan effectively, you also should consider an even less pleasant scenario: the possibility that your children or other family members might die before you.

Failure to consider this possibility and to name contingent beneficiaries can derail your estate plan should the unthinkable happen. Why? Because all the effort you put into planning your estate could be for naught if a primary beneficiary is not there to receive it.

If a primary beneficiary predeceases you and you haven't named contingent beneficiaries for the assets that beneficiary was slated to receive, it will be as if you died without a will. The property will pass to your surviving family members, if any, according to state intestacy laws, and the result may be dramatically different from what you had planned. Even worse, if you have no surviving heirs, your wealth will become property of the state.

To ensure that your wishes are fulfilled, you should name one or more contingent beneficiaries. Your contingent beneficiaries can be virtually anyone you choose, including distant family members, friends or even charitable organizations.

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## A message to clients and friends:

We hope you enjoy this issue of *Estate Planning Insights*. Please visit our website at [www.kelaw.com](http://www.kelaw.com) for previous issues of this newsletter. If there are any topics you would like to read about, please let us know and we will do our best to write about them in an upcoming issue.

The attorneys in the Firm's trusts and estates department are accomplished practitioners in estate planning, administration and litigation. Our clients range from highly compensated individuals to those of more modest means. We also continue to represent for generations certain families of significant wealth. Persons with large or modest estates find comfort in dealing with our seasoned attorneys who understand their planning needs. In addition to our individual clients, we represent charitable organizations, foundations, trust companies and banks.

Our clients seek imaginative methods of accumulating, managing, preserving and transferring wealth. We assist them in building their estates and planning for the transfer of property to family members and other beneficiaries in ways that generally minimize income, gift and estate taxes. We also counsel these clients on planning for future needs such as college education, healthcare and retirement. Depending on the needs of the particular clients, we develop simple or very sophisticated plans and prepare the documents necessary to implement those plans. Our trusts and estates attorneys also draw on the resources of lawyers from our other practice groups to provide our clients with comprehensive advice. In particular, our trusts and estates attorneys work closely with our tax attorneys. Together these groups use their substantial

expertise in estate planning techniques to minimize our clients' present and future tax burdens as well as to preserve wealth.

The Firm recognizes that both individuals and families of significant wealth have exceptional needs. To assist these clients we offer a service we refer to as the "Family Office". Our Family Office practice provides a sophisticated and objective approach to helping families preserve, manage and integrate their wealth and family life in an effective manner. Our services range from tax planning and investment advice to corporate, business and family strategies - all in the context of a traditional legal environment.

Within the trusts and estates department we have talented litigators with significant experience in estate disputes. These attorneys are skilled in handling a variety of contested matters stemming from the distribution of inherited wealth.

Our trusts and estates clients seek more than our legal expertise. They value our discretion, judgment and prompt personal service. Our sensitivity and dedication to our clients' varied needs have made us one of the premier trusts and estates practices.

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