

William Blair

Private Wealth Management

Preserving Family
Wealth Before, During,
and After Marriage



Through a tremendous amount of hard work and careful planning, families can build wealth that creates an enduring legacy across multiple generations. Preserving that wealth, however, becomes more complex with each branch that is added to the family tree.

While affluent families typically put a significant amount of work into mitigating risks related to taxes and market volatility, some of the biggest challenges to a family's wealth can come from marriage, divorce, remarriage, blended families, and other changing family dynamics. With approximately half of marriages in the United States ending in divorce, it is important for families to understand the wealth management considerations related to marriage and take a proactive approach to planning for changes to their family dynamics. This planning is particularly important when ownership of a family business is involved.

Fortunately, there are many strategies that families can use to preserve wealth across generations while strengthening communication and family harmony.

How Divorce Affects Family Wealth

Before we explore strategies for mitigating the effect of divorce on a family's wealth, it is important to look at the role that marital property and separate property (or "non-marital property" as it is called in Illinois and some other states) play in determining how assets are distributed in a divorce.

While the details can vary significantly depending on state law and specific circumstances, the divorced couple's assets are generally identified as either separate property (i.e., property that belongs to just one of the spouses) or marital property (i.e., property that is shared by the spouses and subject to division in a divorce).

The most common forms of separate property include:

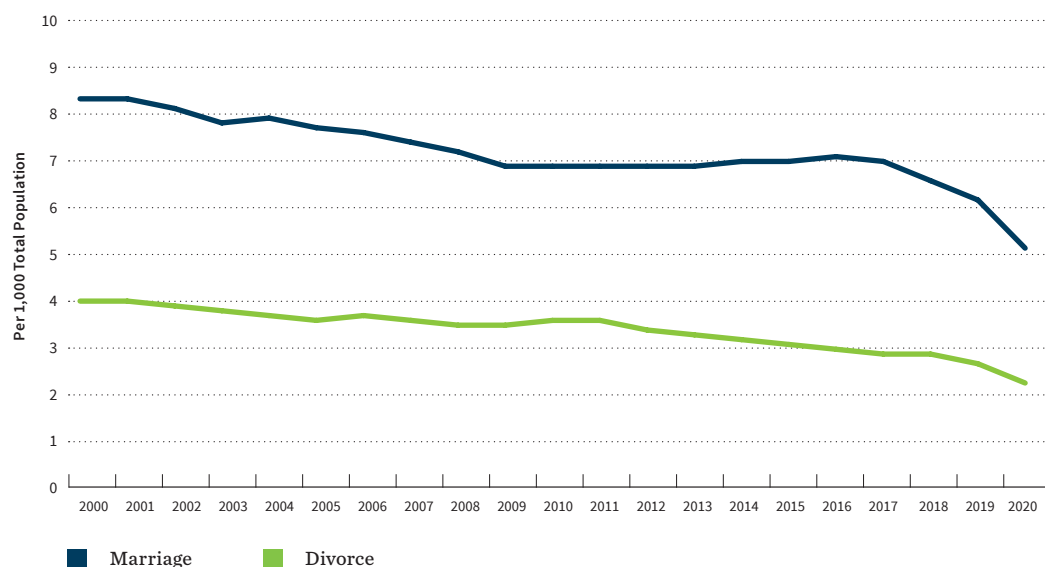
- Property owned by one of the spouses before the marriage
- An inheritance received by one of the spouses either before or during the marriage
- Gifts received by one of the spouses during the marriage

50%

According to the CDC, approximately half of first marriages in the United States end in divorce, and divorce rates are significantly higher for remarriages. While the U.S. divorce rate has been gradually decreasing over the past several decades, it is expected that many people will experience divorce in their immediate or extended families.

U.S. Marriage and Divorce Rates

While divorce rates have gradually declined over the past 15 years, approximately half of all marriages in the United States end in divorce. This underscores the importance of thinking proactively about strategies for minimizing the impact of divorce on the family's wealth.



Source: CDC/NCHS National Vital Statistics System

How Divorce Affects Family Wealth (continued)

Generally speaking, any other property acquired during the marriage is considered to be marital property and thus subject to division in a divorce.

While gifts and inheritances generally are considered to be separate property, there are many situations or circumstances that can cause these gifts to become marital property.

Again, it is important to note that the state laws vary regarding how separate and marital property are determined.

In the next section, we will discuss some of the strategies for mitigating this risk.

Separate vs. Marital Property

Dividing a couple's assets in a divorce can be a complicated, time-consuming, and expensive process. While laws can vary significantly from state to state, it is helpful to understand which types of assets are generally treated as marital property (i.e., property that is shared by the spouses and subject to division in a divorce) vs. separate (or non-marital) property (i.e., property that belongs to just one of the spouses).

Trusts, pre- and post-nuptial agreements, avoiding commingling assets, and proper titling of assets are all techniques that families can use to help protect gifts, inheritances, and other forms of separate property from becoming marital property.



Separate Property

Generally limited to:

- Property owned before the marriage
- Gifts received by one spouse before or during the marriage
- Inheritances received before or during the marriage



Marital Property

Most other types of property acquired by the couple during their marriage, including:

- Income earned by either spouse or property acquired with the income earned by either spouse during the marriage
- Checking, savings, and investment accounts that have joint titles or commingled assets, etc.
- Real estate, automobiles, and other property acquired during the marriage using commingled assets and/or placed in joint title

Strategies for Protecting Family Gifts and Inheritance

Supporting younger generations through an inheritance or lifetime gifts of cash, real estate, stock, shares of the family business, investment portfolios, art, or other assets can be tremendously rewarding for parents and grandparents. While older generations often take great joy in supporting their children and grandchildren as well as their spouses, it is important to realize that without careful planning, a portion of these gifts may leave the family in the event of a divorce or a death.

Fortunately, there are several strategies that can be used to help mitigate the risk of gifts or inheritances being subject to division in a divorce settlement or leaving the family upon the death of your child or grandchild.

Keeping Separate Accounts and Titling Assets Separately

As noted previously, while gifts and inheritances generally are considered to be separate property, there are many situations or circumstances that can cause gifts and inheritances to become marital property. Two of the most common causes of this are couples commingling assets upon getting married or transferring the title of assets they brought to the marriage into joint ownership.

When gifted or inherited assets are commingled with the spouse's assets, those assets can become marital property. For example, if parents give their adult, married son a gift of \$25,000 cash, that gift will be considered marital property if the son puts the cash in a checking account that is held jointly with his wife. In addition to keeping inherited or gifted funds in separate accounts, it is also important to keep documentation that clarifies that the funds were intended to be a gift to just one of the spouses.

How assets are titled can play a large role in determining how those assets are distributed upon divorce or death. This frequently comes into play when gifts are given to help children or grandchildren purchase a home. For example, assume that a couple gives their adult, married daughter \$1 million so that the daughter and their son-in-law can purchase a home in a select school district for the grandchildren. If the new home is titled jointly between the daughter and the son-in-law, then the gift would be considered a joint gift to both spouses.

Memorializing Intent

Documenting the intent of a gift, inheritance, or loan to a loved one can help minimize the risk of the property leaving the family in the event of divorce or death. For example, if parents loan their daughter and son-in-law \$50,000 to help with the down payment on a home, keeping documentation clarifying that the funds were a loan can help ensure that if the young couple were to get divorced, the \$50,000 would be treated as a liability to be repaid rather than a gift to the couple.



Strategies for Protecting Family Gifts and Inheritance (continued)

Using Trusts Effectively

Trusts can be an effective tool for preventing the unintended dilution of family wealth as a result of death or divorce. When used and executed properly, spendthrift trusts, domestic asset protection trusts, and other types of trusts can prevent gifts to younger generations or inheritances from becoming marital property in a divorce or leaving the family upon the death of an offspring. Care must be taken, however, to ensure that the income generated by the assets in the trust is not commingled with the spouse's assets. For situations where children from a previous marriage are involved, qualified terminable interest property trusts, credit shelter trusts (or bypass trusts), and irrevocable life insurance trusts can be used to protect the children's inheritance while providing support for the new spouse.

Paying for Education Expenses

Often gifts can have unintended consequences from a wealth management perspective. It is important for donors to understand how the gift will be treated in the event of divorce or death in the family. A common scenario where unintended consequences arise involves grandparents funding a grandchild's college expenses. To do so, grandparents might put assets in an UTMA or UGMA custodial account, a gift trust, or a 529 college savings plan for the benefit of the grandchild. While an UTMA/UGMA or gift trust can provide valuable flexibility relative to a 529 plan, which can be used only to pay for private elementary, high school and college tuition, using an UTMA/UGMA or gift trust may have adverse consequences if the grandchild's parents were to get divorced.

Due to adverse side effects, it is usually more beneficial for grandparents to pay education expenses directly to the institution versus gifting directly to the grandchild. Direct payments to an educational or medical institution for a loved one's educational and medical expenses do not count against one's annual gift tax exclusion or lifetime gift exemption. This can be a great way to transfer wealth to younger generations without incurring gift or estate taxes. It is important to work with your advisors to understand the potential pros and cons of the various gifting strategies.

Avoiding Unintended Consequences

When giving a gift to a loved one, it is important to work with your advisors to understand how those assets may be treated in the event of death or divorce. For example, putting assets in a trust to pay for a grandchild's college expenses—as opposed to opening a 529 savings plan or paying directly for the grandchild's education expenses—could end up having negative consequences on the family's wealth if the grandchild's parents were to get divorced.



Strategies for Protecting Family Gifts and Inheritance (continued)

Establishing Pre-Nuptial and Post-Nuptial Agreements

One of the most commonly used tools to protect family wealth is a pre-nuptial agreement. According to a 2019 survey of members of the American Academy of Matrimonial Lawyers, 62% of the respondents reported seeing an increase in the number of pre-nuptial agreements over the previous three years. In addition to stipulating which assets will be considered separate property vs. marital property, a pre-nuptial agreement can also establish the amount of alimony payments, inheritances, and other important issues that might otherwise be left up to the courts upon divorce or death.

While pre-nuptial agreements certainly are not necessary in all situations, they can provide an important level of protection and clarity when the couple has a complicated financial situation. Pre-nuptial agreements can be particularly helpful when one or both of the spouses:

- Has children from a previous marriage
- Brings considerable assets or debt to the marriage
- Plans to give up a job or make other financial sacrifices or contributions for the family
- Owns or anticipates inheriting shares of a family business

A pre-nuptial agreement does not need to be a static document for the duration of the marriage. Some couples build a “sunset clause” into their pre-nuptial agreement stating that the agreement terminates after a predetermined number of years. Other times, couples will amend the pre-nuptial agreement to reflect changes in the couple’s financial situation. If, for example, a company that the husband founded grows beyond what the couple envisioned prior to the marriage, both sides can agree to amend the document to account for the new reality.

Like pre-nuptial agreements, post-nuptial agreements are becoming more common. These agreements are often used to protect a large asset given to the couple after the marriage. For instance, parents may provide funds for their son and daughter-in-law to buy a new home on the condition that a post-nuptial agreement is signed requiring that the home is titled in the son’s name only. It is important to note, however, that courts often apply more scrutiny to post-nuptial agreements than to pre-nuptial agreements. Courts may not enforce a post-nuptial agreement if the judge believes that one of the parties was coerced or otherwise pressured into signing the agreement. Thus, more care and forethought needs to be applied to the drafting of a post-nuptial agreement.

Considerations for Family Business

Strategic wealth planning is particularly important when family businesses are involved. Often, a family business represents the largest portion of a family's wealth, and as shares of the business are passed to younger generations, there are concerns about how divorce may dilute the family's ownership stake.

A divorce involving a family business owner can be extremely disruptive to both the family and the business. When thinking about how to minimize potential disruptions and protect the value of the company that your family worked so hard to build, it is vital to consider the following issues.

Retained Earnings vs. W-2 Income

One of the biggest issues that can jeopardize a family member's stake in the business in the event of a divorce is the allocation of the company's cash flows among W-2 compensation, dividends, and retained earnings. Typically, the compensation that the family member receives as W-2 income will be treated as marital property; the dividends that the family member receives will be treated as 1) marital property if the funds are commingled with the spouse's funds or 2) separate property if the funds are not commingled; and the family member's claim on the company's retained earnings (i.e., profits that are not distributed as dividends) is treated as separate property.

Those retained earnings, however, which often represent a substantial portion of the business's value, may be treated as marital property in a divorce, if the amounts paid out as W-2 income are too low. If the courts deem that the company was paying inappropriately low W-2 income to the shareholders as a way to shield that wealth from spouses, the court may award a portion of the company's retained earnings to the spouse in a divorce settlement. It is important to note that this can occur even if the family member does not own a controlling share of the company's stock. Even though a family member with a minority ownership stake does not have legal control over the compensation decisions, courts in recent years have

sometimes ruled that a child with 30% ownership, for example, may exert "familiar control" because of the child's relationship with the parent who founded the company.

A simple example illustrates how this dynamic can play out. Suppose a father started a company 30 years ago and his three children began working at the company full-time after graduating from college. In addition to paying the children a regular salary and year-end bonuses, the father also gives each of the children a small percentage of the company's shares each year. Fast forward 15 years, and the oldest son, who has now been married for 10 years, has a sizable minority ownership stake in the company. If the son were to get divorced, to determine whether the wife has a claim to any of the company's retained earnings, the courts would look at whether the amounts that the son was paid in income and dividends were adequately large. If not, the courts may treat a portion of the retained earnings as "disguised compensation" and award a portion of the husband's shares (or other property of equal value) to the ex-wife.

So what could the family have done to minimize this risk? The best way to protect against this outcome is to a) have an accountant or other objective third-party advisor determine a competitive salary for family members' work in the business and b) document the rationale for determining those salaries. The company should hold annual meetings with its accountant and advisors where the rationale for the compensation levels and amount of retained earnings are discussed and formally documented. While these steps may not eliminate the risk of the familiar control issue described above, family meetings and proper documentation can go a long way in protecting the retained earnings.

Considerations for Family Business (continued)

Gift vs. Selling Shares to the Next Generation

If a child or grandchild receives ownership shares in a family business via gift or inheritance while married, those shares are generally treated as separate property (aside from the retained earnings concerns described above). Often, however, the older generation may choose to pass the shares down through a purchase agreement rather than an outright gift.

While selling the shares can provide valuable liquidity for the older generation, this strategy can put the shares at risk in the event of a divorce. Shares acquired via a purchase agreement will become marital property unless the shares are purchased entirely with separate assets that have not been commingled with the spouse's assets. Structuring the transfer as a gift—and documenting that it is intended to be a gift to the child only and not to the couple—can help keep these shares in the family.

Buy-Sell Agreements and Shareholders' Agreements

With family businesses and other closely held, private companies where there is no market for the company's shares, major problems can arise when one of the owners dies, gets divorced, retires, or otherwise wants to sell his or her shares. By creating rules for whom the shares can be transferred to, how the shares will be valued, and what mechanisms will be used to execute the transfers, shareholders' agreements and buy-sell agreements can play a vital role in preserving the value of the company and minimizing disruptions during a period of transition. It is important to note, though, that while a buy-sell agreement may be helpful evidence in establishing the value of the company in a divorce proceeding, the buy-sell agreement likely will not be determinative of the company's value.

The Four Phases of Wealth Management

Creating enduring wealth that spans multiple generations requires careful planning and strategic thinking at all stages of your financial life.



Considerations for Remarriage and Blended Families

Thinking strategically about the wealth management implications of marriage makes sense regardless of the circumstances, but it is particularly important for remarriages and marriages involving blended families. The strategies listed here can be very helpful in preserving family harmony and protecting the interests of children from previous marriages and the new spouse.

Communication is paramount

The most valuable strategy for remarriages and blended families does not require a financial planner or an attorney to execute. Communication among the parent, children, and new spouse is extremely important. Often when a parent with significant wealth gets remarried, the children have concerns about what the marriage will mean for their inheritances. Likewise, the new spouse may have concerns about how he or she will be supported if the other spouse were to die or if the marriage ends in divorce. Straightforward communication about what the spouse will receive and what the children will receive can eliminate much of this tension and promote family harmony.

Consider a pre-nuptial agreement

While pre-nuptial agreements are not necessary in many situations, they often are advisable for remarriages, especially when there are children from previous marriages. By clearly articulating how the couple's assets will be divided upon death or divorce, a pre-nuptial agreement can be used to protect assets that the individual intends to pass on to his or her children from becoming marital property. For example, if a mother wants to ensure that her ownership shares in the family business go to her children from a previous marriage, a pre-nuptial agreement can be used to stipulate that the shares will not go to the new spouse or children from the new marriage.



Considerations for Remarriage and Blended Families (continued)

Enhance your estate plan

There are various types of trusts that can be used to simultaneously protect the inheritance of the children from a previous marriage while providing support for the surviving spouse. A qualified terminable interest property (QTIP) trust, which uses the marital deduction for estate and gift taxes, can be a tax-efficient way of accomplishing these goals. With a QTIP, the surviving spouse receives income from the trust for the remainder of his or her life but does not have access to or control over the assets in the trust. Upon the death of the surviving spouse, the assets in the trust pass on to the beneficiaries (usually the children). Other examples of trusts that can be used to protect the inheritances of children while providing support for the new spouse include a credit shelter (or bypass) trust and an irrevocable life insurance trust.

Review beneficiaries and estate planning documents

Whenever there is a divorce and remarriage, it is important to review your will, powers of attorney, trusts, life insurance policies, retirement accounts, and other accounts to ensure that the beneficiary and trustee information reflects your intentions. While state law will supersede any outdated information in some cases, it is good practice to regularly review and update these documents whenever a major life event occurs.

40%

Four of every 10 marriages in the United States is not a first marriage for one or both of the individuals, according to the Pew Research Center. Remarriages involve a unique set of wealth management considerations, especially when there are children from a previous marriage.

Building a Team of Advisors

With each branch added to your family tree, your wealth management needs become more complex.

Goals such as preserving family wealth, transferring ownership of a family business, and supporting younger generations as they launch their careers and start their families involve a myriad of considerations related to portfolio management, taxes, risk management, matrimonial law, and estate planning. It is important to have a team of trusted advisors who can work together to help you navigate these multifaceted challenges and opportunities.

At William Blair, our wealth planners are dedicated to helping high-net-worth families build and preserve their wealth and create an enduring financial legacy for generations to come. Through an ongoing dialogue with our clients, we deliver comprehensive wealth management solutions for our clients' evolving needs.

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