

How Estate Planning Professionals Can Add Value During a Divorce Process

Waukesha County Estate Planning Council Meeting
Thursday, October 20, 2016

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I. Goal of Presentation.

The goal of this presentation is to share important information about the divorce process and its relationship with estate planning. Although this is not a treatise on the subject, the information below can help inform the estate planning professional about potential issues regarding divorce and estate planning. With this information, the estate planning professional can add value for the client by being aware of potential problems before a divorce, and can add value by working with the divorce lawyer to protect all members of the family during and after a divorce.

II. Issues to know BEFORE a divorce.

- A. Is this a marital property state for divorce? Wisconsin is one of the few states in which the answer is “it depends.” Wisconsin is a marital property state for the period in which the parties are married. In divorce, the division of assets and debts is not based upon marital property; rather, the division of assets and debts is based upon “equitable distribution.” The divorce law presumes that all assets, regardless of title, how acquired, or when acquired (before or after the marriage), are *divisible*. There is a presumption that the entire divisible estate is divided equally. There are 13 factors for the courts to apply to determine whether there should be a deviation from the presumption of equal division.

There is an exception to the rule that all assets are divisible. Assets that are acquired from a gift or inheritance (or from the proceeds of the sale or transfer of the gift or inheritance) are not divisible as long as the asset remains in the donee's name and can be separated from non-gifted or non-inherited property. For example, the principle amount of an investment fund received as an inheritance is not divisible, but the realized income from the investment fund needs to be segregated out so that the income portion is divisible. Market appreciation of assets (house, stock) is not divisible. There is a difference between passive appreciation (i.e., market conditions) and active appreciation (specific personal efforts and application of monies to increase the value of an asset).

Adding Value: Sweep accounts are highly recommended. The purchase of additional stocks from stock income is extremely dangerous (watch out for comingling and transmutation).

- B. If the marital property laws do not apply in a divorce, what good is a prenuptial agreement? A prenuptial agreement is invaluable in many cases (if done correctly). The prenuptial agreement classifies assets, and then provides how the assets are divided in the unlikely event of a divorce. The prenuptial agreement essentially defines the divisible estate. Prenuptial agreements are binding in a divorce if they are entered into freely, voluntarily, and with full financial disclosure. The prenuptial agreement must be fair at the creation and fair at the enforcement.

Adding Value: Prenuptial agreements are more and more common and do not have to be viewed as a form of oppression of one spouse by the other. In the right case with the right parties, extensive planning and creativity can occur that may have long-term, positive effects.

- C. What is all of this talk about “no-fault divorce?” The concept of no-fault divorce is misunderstood. In the old days, a spouse seeking a divorce would need to prove that the relationship was irretrievably broken for specific reasons caused by the other spouse. The Divorce Reform Act eliminated a spouse having to prove that the other spouse did something that caused the dissolution of the relationship. The Divorce Reform Act stated that the division of property or the determination of support could not be influenced by the reason for the dissolution (i.e., adultery). But, other forms of “fault” are highly

relevant: hiding assets, wasting assets, intentionally not working to one's income potential, trying to murder the other spouse, kidnapping children, etc. "No fault" divorce is not an excuse to do anything to the other spouse!

Adding Value: A spouse's unilateral or sudden gifting to children or third parties can be deemed an improper transfer of divisible assets. There is a presumptive one-year "look back" prior to the filing for the divorce, or a longer "look-back" if evidence is shown that assets were transferred. In that case, transferred assets are added back into the divisible estate and the transferring spouse is deemed to have received the assets in his or her half of the property division.

- D. A word about process: A couple is married in Wisconsin until they are divorced. While there is such a thing as a "Judgment of Legal Separation" at the conclusion of the process, the parties are not "legally separated" while they are going through the process. The ability of a spouse to incur debt for which the other spouse is responsible, and for creditors to collect on marital debts from either spouse, is alive and well during a divorce. The agreements and court orders regarding debts incurred during a divorce are between the parties and are not binding on third-party creditors.

Depending on the county, a divorce can take from six months to two years. A divorce cannot happen less than 120 days unless there are extraordinary circumstances (impending death, deployment, bankruptcy).

Adding Value: Parties can prospectively "opt-out" of community property income reporting requirements for the filing of tax returns and the payment of income taxes before a divorce is granted. This can be beneficial to a family, particularly if they have children. A knowledgeable accountant or tax attorney can run tax scenarios to determine whether an "opt out" is advisable.

Adding Value: It's important to have a clear, clean record of all debts and personal guaranties the parties are responsible for. Signed copies of all debt instruments, personal guaranties and spousal consents should be maintained by the parties and/or their estate planning advisor.

- E. Are there considerations for a business owner before a divorce?
Yes!
1. Good records concerning stock ownership are critical (stock register, up to date stock certificates, etc.).
 2. Good financial documents and record keeping are critical.
 3. Incurring debt may lower the value of a business, but it also limits some of the options for the property division payment. If the business is being gifted to a spouse from the spouse's family, the stock register, gift tax returns, corporate minutes, letter or memo outlining the intent and any formal or informal valuations are important to establish which portion of the business is a gift and which portion is not a gift.
 4. If stock is "bonused" to an employee during a marriage, it is generally treated as income and included as a marital asset. Plan carefully and execute any needed documentation prior to the stock bonus.
 5. If the business is being gifted to a spouse's child or children, the stock register, gift tax returns, minutes, letter or memo outlining the intent and any valuations are important to establish the remaining divisible amount of the ownership interest in the business.
 6. Other documents, such as Shareholder Agreements, Buy/Sell Agreements, Operating Agreements, Partnership Agreements, board of director resolutions and minutes, and stock registers are also important.
 7. Are there pros and cons of the form of the business? C corp. S corp. Schedule C? Partnership? LLC?
- F. Are life insurance trusts divisible? No. Life insurance trusts are not part of the divisible estate. The issue regarding life insurance trusts in a divorce centers on whether and how the trust continues to be funded in order to pay the life insurance premiums.
- G. What is the impact of Trusts on a divorce?

1. An irrevocable trust is irrevocable and a divorce judgment cannot change the trust's status.
2. A trust in which the spouse has not created, and the spouse is only a beneficiary, is not divisible in a divorce. However, the existence of the trust and the fact that a spouse is a beneficiary is required to be disclosed.
3. A trust in which the spouse has created could be divisible in a divorce under certain circumstances.
4. Regardless, of how the trust is created, any income from the trust to the spouse is available for both child support and maintenance (spousal support).

Adding Value: In some instances, the income from a third-party trust to a spouse is classified as a gift to the spouse and not divisible. A spouse that is a beneficiary of a third-party trust should be advised to place the income from the trust in an account titled solely in his or her name and kept separate from any other asset.

III. Issues to know DURING a divorce.

- A. Issues for business owners.
 1. A common fear among business owners is that he or she will "lose" the business. It is rare that a business owner loses a business as a result of the divorce.
 2. Goal is to structure and maintain the business consistent with the objectives of the parties (Often legacy and cash flow).
 3. Use the divorce as an opportunity to revisit the estate plan and refresh all areas.
 4. A business valuation is not needed for divorce purposes if the parties can agree on a value. If a business valuation is needed, the standard of value is Fair Market Value for the ownership interest (controlling vs. non-controlling). The value is added to the divisible estate, and then the non-owning

spouse will receive other assets equal to the value of the business and/or a structured equalization payment.

5. Some spouses have shared ownership interests in the business. This does not change the way the business is valued or divided in a divorce, but may change the way the ownership interest is held (often a trust is formed with the active spouse being the trustee and both spouses being a beneficiary). It is uncommon, but not prohibited, that the spouses maintain co-ownership after the divorce. *This is successful in the rarest of cases!*
6. Many business owners received all or part of their ownership interest as a result of gifting or inheritance. In these cases, the difference between active and passive appreciation can make an enormous difference on which part is divisible in the divorce.
 - a. Is there a difference between an increase in the tangible assets of a company (i.e., retained earnings) vs. appreciation in the intangible assets of the company?
 - b. What about a controlling interest vs. a non-controlling interest?
 - c. How do you measure appreciation?
7. One way to make the “division” of the business more palatable to the business owner and the non-business owner spouse is to incorporate gifting plans to their children. In that situation, the income is generally separated from the business itself. The income is shared between the divorcing spouses, and the value of the business is less important as it is transferred to the next generation.

Adding Value: Working with the divorce lawyers, either as a consultant for one spouse or the neutral consultant for both spouses, can create a tremendous amount of options for the transfer of the business asset to the next generation, planning for the potential sale of the business, and saving considerable income and/or estate taxes.

B. Other issues during a divorce.

1. Upon the commencement of a divorce, there is a statutory “restraining order”. The relevant portion for our discussion provides:

Encumbering, concealing, damaging, destroying, transferring or otherwise disposing of property owned by either or both of the parties, without the consent of the other party or an order of the court, except in the usual course of business, in order to secure necessities or in order to pay reasonable costs and expenses of the action, including attorney fees.

There is no specific prohibition against changing an estate plan during the divorce. Some courts and divorce lawyers believe that the prohibition against “transferring or otherwise disposing of property” applies to estate planning changes.

2. If a party dies during a divorce action, then the family court loses jurisdiction to proceed and the case is immediately dismissed. The surviving spouse proceeds as if a divorce was never filed.
3. Investment portfolio’s (current and retirement) – Consider having the parties meet with the family investment advisor to create an investment plan that meets the objectives of the parties and provides for the needs of the parties given the types of assets held, the time horizon until retirement, the household budgets and the risk tolerance of each party.
4. Beneficiary designations
 - a. State statutes control the beneficiary designations and joint ownership of certain assets, but only after a divorce is granted.
 - b. Federal law controls the beneficiary designations on ERISA-type benefits. The U.S. Supreme Court has ruled that the federal law trumps state law on beneficiary designations and trumps provisions in a divorce judgment.

5. Life Insurance

- a. The family court has the authority to order a party to continue, increase or obtain life insurance with the children as beneficiaries. The ability for the court to make such an order falls under the general category of child support.
- b. The ability for a family court to order a party to continue, increase, or obtain life insurance with the former spouse as a beneficiary is undetermined. Maintenance (spousal support) ends upon the death of either party. The argument against using life insurance for the benefit of the maintenance payee upon the payor's death is that the obligation ends by statute upon the payor's death and therefore, there is not an "insurable interest."
- c. If the parties agree to provide life insurance with the other as a beneficiary or the children as beneficiaries, and the agreement is part of the Judgment of Divorce, then the agreement is enforceable. If a party fails to follow the judgment, then court proceedings are likely to follow.

Adding Value: If you are asked to provide information as to an existing life insurance policy, it is important to provide the following information: policy number, ownership, beneficiary, death benefit amount, cash surrender value, term of the contract, the amount of the premium and whether the amount is adjustable. Sometimes the ownership of the policy will be transferred between spouses and all of the information aids in making that decision.

- C. Spouses in a divorce should always give full disclosure! Failure to provide full disclosure is not only actionable under the "contempt" process, but undisclosed assets are subject to division upon discovery regardless of whether the asset was divisible or not.

Adding Value: If you are requested to provide information about retirement assets, it is critical to provide the kind of retirement asset. For example, a 401(k) may have both a Roth and a non-Roth component. Each component is valued differently in a divorce.

Another example is that some Roth IRAs cannot be transferred within certain periods of time after being converted from a regular IRA. It is critical to know the limits on transferring or liquidating to make sure the Roth IRA can be divided/transferred with no unintended tax consequences.

- D. Can a divorce judgment provide for estate planning? The family court can order, and the parties can agree, to provide estate planning in a divorce judgment for minor children because such estate planning is in the nature of child support. There are also some statutory provisions allowing property to be set aside for minor children. A family court cannot, without agreement, do estate planning for adult children because adult children are not eligible for child support and the property division statutes apply only the parties and to minor children. However, if the parties stipulate to a property division in which the adult children are beneficiaries, and the stipulation is part of the judgment of divorce, then such stipulation is enforceable. A party, or the party's attorney, who violates the terms of the stipulation made part of the judgment, is subject to variety of legal actions and sanctions.

- E. Does the pending sale of a house or other jointly-owned property prevent the divorce from being completed? No. Divorce judgments are frequently granted with the sale of assets to be accomplished after the divorce.

- F. What happens when both spouses want an asset? As a general rule, the spouse that wants an asset will be awarded the asset at fair market value. If neither spouse wants an asset, then the asset is sold and the proceeds divided to accomplish an overall equal division of the divisible estate. There are situations in which both spouses want to be awarded an asset, and this is typically a second home, such as a family cottage, northern Wisconsin property, or a vacation home. There are several options: placing the property in a trust with spouses as trustees and children as beneficiaries, simply co-owning the property, or placing the property into a Qualified Personal Residence Trust. Each option has different execution and taxation issues. Depending upon the option selected, the Judgment of Divorce can set forth many of the provisions which then become enforceable as a judgment.

IV. Issues AFTER a divorce.

- A. There are many actions to take after a divorce is completed that do not need much discussion: changing beneficiaries consistent with the divorce judgment, adjusting life insurance provisions consistent with the divorce judgment, changing the estate plan, changing financial and health care power of attorneys. In many cases, a prenuptial agreement for a subsequent marriage is advisable. Attached is an article by Eido Walny published in the *Wisconsin Journal of Family Law* that addresses many of these post-divorce action steps.

Adding Value: the recipient of spousal support (maintenance) can use a portion of the income to fund an IRA or Roth IRA. Most recipients are unaware of this option and can benefit from the information.

Adding Value: many divorce judgments that provide for life insurance for children will require the party to list the children as beneficiaries or “for a trust for their benefit.” Creating a trust for the benefit of the children with the life insurance proceeds provides many opportunities. When doing an estate plan for a divorced spouse, an examination of the life insurance provision may be helpful to the spouse and his or her children.

- B. Business post judgment considerations:
1. Both parties should have the common goal of keeping the company healthy for family legacy perspective and income for support perspective.
 2. Forecast out owner cash needs for:
 - A. Equalization payments
 - B. Child support payments
 - C. Spousal maintenance payments
 - D. Income tax payments
 3. Revisit succession plan given the change in circumstances (sale, gift, grooming of successors, etc.).
 4. Revisit involvement of the children

5. Don't ignore positioning the company for the eventual retirement of the owner.
 6. Rethink growth strategy
 7. Rethink any acquisition strategies
- C. Does a new spouse's income impact the divorced party's child support and/or maintenance obligation? No. There are several court reported cases that make clear that a divorced spouse's support obligations are determined as if the divorced spouse is single. Marital Property Law does not allow the income of new spouse to be available for the support obligation of the divorced spouse. However, if the divorced spouse is claiming that he or she does not have the ability to pay support, or does not have the ability to pay an arrear, then the income of the new spouse will be relevant only to the degree to which the divorced spouse's living expenses are reduced by virtue of the marriage so as to increase the ability to pay.

The shifting of compensation or business income from a divorced spouse to their new spouse is a thorny issue and the resolution will be based on the specific facts and circumstances.

Adding Value: A judgment of divorce requires spouses to share financial information annually as long as there is a child support obligation between them. In the case of high-conflict divorces, it may be advisable that subsequently married parties execute an income classification agreement in order to file separate income tax returns. Alternatively, we've seen it where the divorced spouse provides the source documents for their sources of income and the tax preparer issues a letter that the sources of income is complete.

- D. How are college expenses treated after the divorce? A family court cannot order a party to pay college expenses with income earned after the child is no longer eligible for child support. In rare cases, a family court can divert a portion of child support into a trust or an account for the benefit of the children, and the trust or account can be used for college expenses after child support ends. If the parties agree on their own to contribute to college expenses and the agreement is part of the Judgment of Divorce, then the agreement is enforceable even though the court could not have ordered it.

Adding Value: there are many mechanisms to provide for a child's college expenses, and many parties will reach an agreement to pay for an expense, or find themselves obligated to do so, but do not know all of the options available to accomplish the savings.

V. Conclusion

With the above information, the estate planning professional can add value to his or her client by being aware of potential problems before a divorce, taking steps for his or her benefit as a result of the divorce, and can add value by working with the divorce lawyer to protect all members of the family during and after a divorce.

THOUGHTS? IDEAS? QUESTIONS?