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"INCOME AND ESTATE TAX IMPLICATIONS OF DIVORCE AND RELATED TOPICS”

October 16, 2012

Renaissance Woodbridge Hotel
Iselin, NJ

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INCOME AND ESTATE TAX IMPLICATIONS OF DIVORCE AND RELATED TOPICS

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I. Filing Status

A. If divorcing couple are married on the last day of year they must file income tax return jointly or married filing separately

B. If the divorcing couple are separated but have not obtained a final decree of divorce or legal separation by the last day of the year they are considered to be married

C. A Taxpayer is considered head of household if:

1. Spouse is not a member of the household for the last six months of year

2. The Taxpayer must furnish over one-half of the costs of maintaining the house

3. The Taxpayer's house must be the principal residence of a dependent child for more than half the year.

II. Joint Returns

A. Signing joint returns makes spouse jointly and severally liable for the tax on the return for that year. The tax liability for prior years are not discharged as a result of divorce

1. The filing of joint returns typically results in less overall tax liability for the couple

2. Negotiate the filing of joint returns for as many years as possible as part of divorce settlement

III. The Innocent Spouse Rule Has Been Liberalized as a Result of the Enactment of the Internal Revenue Service Restructuring and Reform Act of 1998

A. Congress dramatically expanded the Code's innocent spouse provisions when it enacted IRC Section 6015. Under this legislation, a taxpayer has three different approaches to pursuing innocent spouse relief:

1. The traditional innocent spouse approach was revised to make it easier for a taxpayer to qualify as an innocent spouse

2. The separate liability election for spouses who no longer are married, or are legally separated or have lived apart for at least 12 months. This provision is much more advantageous for taxpayers than the traditional approach, because the burden of proof on the knowledge component is shifted to the IRS

3. A taxpayer may seek innocent spouse relief on equitable grounds if the taxpayer is ineligible under either of the above two approaches

B. How to Initiate Innocent Spouse Relief.

1. A request for innocent spouse relief is initiated by the submission of Form 8857 (Request for Innocent Spouse Relief). See copy attached hereto as Exhibit A

2. If a spouse's overpayment was (or is expected to be) applied against the other spouse's debt, a Form 8379 (Injured Spouse Claim and Allocation) should be filed with IRS. See copy attached as Exhibit B

C. Traditional Innocent Spouse Relief. Relief under IRC Section 6015(b) generally will absolve the requesting spouse of any tax debt with respect to the years in issue. The criteria for relief are as follows:

1. Joint Return

a. In order to be eligible for relief under IRC Section 6015, the requesting spouse must have filed a joint return with the non-requesting spouse

b. Under the final IRC Section 6015 Treasury Regulations, if an individual can establish that he or she signed a return under duress, the return will not be a joint return, and the individual will not be jointly and severally liable for the tax shown on the return or any deficiency with respect to the return

c. If the requesting spouse establishes this position, each spouse will be treated as having filed a separate return and will not be entitled to the benefits of a joint return (e.g., the earned income credit, the joint return rates, or innocent spouse relief)

d. The return will be adjusted to reflect only the tax liability of the individual who voluntarily signed the return, and the liability will be determined at the applicable rates for married individuals filing separate returns

e. The requesting spouse will be liable for any tax on his or her income and should take appropriate steps to file his or her own separate return

2. Knowledge of the Understatement

a. Knowledge of the understatement of tax is an issue not only under IRC Section 6015(b) but under the other two relief provisions as well. It can make or break a claim under IRC Section 6015(b) or (c), and under certain circumstances IRC Section 6015(f) as well

i. Under IRC Section 6015(b), if the requesting spouse cannot prove that he or she lacked actual knowledge and had no reason to know of the deficiency, relief will not be granted

ii. Conversely, under IRC Section 6015(c), relief will be denied only if the IRS can prove that the requesting spouse had actual knowledge

iii. IRC Section 6015(f) does not contain an explicit knowledge requirement but, as discussed later in more detail, the Treasury Regulations give considerable weight to the knowledge issue, both actual and reason to know, in determinations under this provision. In addition, Rev. Proc. 2003-61 sets forth a revised statement of the weight IRS will give this factor

b. Under Reg. Sec. 1.6015-2(c), a "requesting spouse has ... reason to know of an understatement ... if a reasonable person in similar circumstances would have known of the understatement." All of the facts and circumstances are considered in determining whether a requesting spouse had reason to know. These include, but are not limited to:

i. The nature of the erroneous item and the amount of the erroneous item relative to other items

ii. The couple's financial situation

iii. The requesting spouse's educational background and business experience

iv. The extent of the requesting spouse's participation in the activity that resulted in the erroneous item

v. Whether the requesting spouse failed to inquire, at or before the time the return was signed, about items on the return or omitted from the return that a reasonable person would question

vi. Whether the erroneous item represented a departure from a recurring pattern reflected on prior years' returns.

3. Equity

a. The requesting spouse must show that under all of the facts and circumstances it would be inequitable to hold him or her liable for the deficiency. Under Reg. Sec. 1.6015-2(d), the factors that will be considered are:

i. Whether the requesting spouse significantly benefited from the understatement

ii. Whether the requesting spouse has been deserted by the non-requesting spouse

iii. Whether the spouses are divorced or separated

iv. Whether the requesting spouse received a benefit on the return from the understatement

b. If the requesting spouse had knowledge of some, but not all of the transactions giving rise to the understatement, the spouse will be granted relief from joint liability for the portion of the understatement of which the requesting spouse did not know or have reason to know, but will remain jointly liable for the portion of the understatement of which the spouse had or should have had knowledge

4. Timing of Election

a. Under IRC Section 6015(b)(1)(E), an election under IRC Section 6015(b) must be made no later than the date that is two years after the date on which the IRS began collection activities with respect to the individual making the election. Collection activities include:

(i) An IRC Section 6330 notice (a notice of the right to a hearing before a levy is made on any property or right to property)

(i) An offset of an overpayment of the requesting spouse against a liability under IRC Section 6403

(ii) The filing of a suit by the U.S. against the requesting spouse for the collection of the joint tax liability

(iii) The filing of a claim by the U.S. in a court proceeding in which the requesting spouse is a party or which involves property of the requesting spouse

b. Collection activities do not include (1) a notice of deficiency, (2) the filing of a notice of federal tax lien, or (3) a demand for payment of tax

D. <u>Separate Liability Election</u>. Under IRC Section 6015(c), a requesting spouse may elect to allocate a deficiency, arising from a joint return, if the requesting spouse is (1) "no longer married to, or is legally separated from," the individual with whom the joint return was filed, or (2) is "not a member of the same household as the individual with whom such joint return was filed at any time during the 12-month period ending on the date such election is filed". Relief from the liability may be limited to the extent that a portion of the deficiency attributable to the erroneous item is allocable to the requesting spouse

1. The requesting spouse may only seek relief from liabilities yet unpaid. This provision applies only to deficiencies and will not provide the requesting spouse with a refund of those liabilities that already have been paid. If a refund is desired, the requesting spouse must seek relief under IRC Section 6015(b) or (f). If the liability is not a deficiency but the result of taxes reported but unpaid on the tax return, relief is available only under Section 6015(f)

2. Status Prerequisites

   a. The applicability of IRC Section 6015(c) depends on the requesting spouse's being no longer married, being legally separated, or not being a member of the same household (for at least 12 months) as the non-requesting spouse. A person is no longer married if he or she is widowed or divorced

   b. For the taxpayer to be eligible for relief under IRC Section 6015(c), the status of the marriage must be established as of the time the requesting spouse files a claim for relief. In the case of a deceased requesting spouse, the marital status will be determined on the earlier of the date of the election or the date of death. If the requesting spouse cannot establish this element, relief under IRC Section 6015(c) will not be granted

3. Actual Knowledge

   a. In an attempt to make relief more accessible, the separate liability relief provision does not apply the hypothetical reasonable person standard but instead looks to the taxpayer's actual, subjective knowledge. In addition, the difficult burden of proving such knowledge is placed on the IRS

   b. All of the facts and circumstances will be considered in determining whether the requesting spouse had actual knowledge. Under Reg. Sec. 1.6015-3(c)(2)(iv), some of the items to be considered are:

      (i) Whether the requesting spouse made a deliberate effort to avoid learning of the item

      (ii) Whether the requesting and the non-requesting spouse jointly owned the property that resulted in the erroneous item

      (iii) The complexity of the transactions

      (iv) What facts the spouse knew regarding the transaction or the source of omitted income

c. Abuse Exception

(i) Under Reg. Sec. 1.6015-4(d), a spouse who signs a return under duress will not be liable for any deficiency on the return. The IRS will treat the return as a separate return of the non-requesting spouse. A requesting spouse in an abusive situation who does not establish that he or she signed the joint return under duress and elects relief from joint liability under IRC Section 6015(c) can receive such relief regardless of the requesting spouse's knowledge of the erroneous item at the time the return was signed

(ii) If a requesting spouse establishes that he or she was the victim of domestic abuse prior to the time the return was signed, and that, as a result of the prior abuse, the requesting spouse did not challenge the treatment of any item on the return for fear of the non-requesting spouse's reprisal, the actual knowledge limitation will not apply. Establishing prior abuse can be difficult. Generally the court requires more than just the self-serving testimony of the requesting spouse

d. Disqualified Asset Presumption

(i) Reg. Sec. 1.6015-3(c)(A)(3)(ii) defines disqualified assets as "any property or right to property that was transferred from the non-requesting spouse to the requesting spouse if the principal purpose of the transfer was the avoidance of tax or payment of tax (including additions to tax, penalties, and interest)." If a spouse requests relief and the Service determines that an asset was transferred with the principal purpose of avoiding tax or the payment of tax, the spouse who received the asset will have his or her portion of the liability increased. Any property transferred within one year prior to the Service's sending a first notice of a proposed deficiency will be presumed to be a disqualified asset

(ii) The requesting spouse may rebut this presumption by showing another purpose for the transaction. For example, if the spouse can establish that the

property was transferred pursuant to a divorce decree, the presumption will not apply

(iii) Property transferred pursuant to a divorce decree will not be presumed to be a disqualified asset, but still may be subject to the principal avoidance of a tax test or a fraudulent scheme. If the IRS can establish that the requesting spouse received an asset in a divorce decree, the purpose of which "was the avoidance of tax or payment of tax, the asset will be disqualified, and its value will be added to the amount of the deficiency for which the requesting spouse remains liable"

e. Allocating the Deficiency

(i) Under IRC Section 6015(d)(3), items generally are to be attributed to the spouses for purposes of IRC Section 6015(c) in the same manner as they would have been had the spouses filed separate returns. If a deficiency is fully attributable to the non-requesting spouse, the entire liability will be allocated to the non-requesting spouse

(ii) If a portion of the liability is attributable to the requesting spouse, the non-requesting spouse also must make an innocent spouse election to seek relief from that portion of the liability in order to have that portion of the liability allocated to the original requesting spouse. When allocating the deficiency between the spouses, the IRS will take into consideration not only any tax benefits but also any fraud by either spouse

(iii) The IRS may allocate any item between the spouses if it establishes that the allocation is appropriate because of fraud by one or both spouses. For purposes of IRC Section 6015(c) fraud is "any fraud of either spouse including, but not limited to, the fraudulent alteration of documents, the fraudulent filing of a return or claim for relief, or any other fraud that may be relevant to the claim of relief"

E. <u>Equitable Relief</u>. IRC Section 6015(f) states: "Under procedures prescribed by the Secretary, if (1) taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid

tax or any deficiency (or any portion of either); and (2) relief is not available to such individual under subsection (b) or (c), the Secretary may relieve such individual of such liability." Several issues immediately arose under IRC Section 6015(f) with regard to the scope of authority for the IRS and the Tax Court, who could seek relief under this provision, and in the circumstances in which equitable relief would apply. The IRS remedied some of these omissions in Rev. Proc. 2000-15, 2000-1 CB 447, which has been superseded (generally effective 11/1/03) by Rev. Proc. 2003-61, which itself was updated in Notice 2012-8, 2012-4 IRB 309

1. Threshold Conditions

   a. Both Rev. Proc. 2000-15 and Rev. Proc. 2003-61 list threshold conditions that must be satisfied before the IRS will consider a request for equitable relief. Once all of the conditions are met, the Service will look at all of the facts and circumstances to determine if it would be inequitable to hold the taxpayer liable. The threshold conditions are as follows:

      (i) The requesting spouse filed a joint return for the tax year in issue

      (i) Relief is not available under IRC Section 6015(b) or IRC Section 6015(c)

      (ii) Relief is requested no later than two years after the date of the Service's first collection activity after July 22, 1998 with respect to the requesting spouse

      (iii) No assets were transferred as part of a fraudulent scheme

      (iv) There were no disqualified assets transferred to the requesting spouse. If such a transfer did occur, relief will be available only to the extent the income tax liability exceeds the value of the disqualified assets

      (v) The requesting spouse did not file the return with fraudulent intent

   b. "Safe harbor" relief where there is an underpayment. Once the threshold conditions have been met, Section 4.02(1) of Rev. Proc. 2003-61 sets forth the circumstances under which IRS ordinarily will grant equitable relief with respect

to an underpayment on a joint return. All of the following elements must be satisfied for the requesting spouse to come within this "safe harbor":

(i) On the date relief was requested, the requesting spouse was no longer married to, or was legally separated from, the non-requesting spouse, or had not been a member of the same household as the non-requesting spouse at any time during the 12-month period ending on the date of the request

(ii) At the time the return was signed, the requesting spouse had no knowledge or reason to know that the tax would not be paid by the non-requesting spouse. The requesting spouse must establish that it was reasonable for him or her to believe that the non-requesting spouse would pay the reported liability. If a requesting spouse otherwise would qualify for relief under this provision except that the required lack of knowledge or reason to know relates only to a portion of the unpaid tax liability, the requesting spouse may receive relief to the extent that the liability is attributable to that portion

(iii) The requesting spouse will suffer economic hardship if relief is not granted

(iv) Under Rev. Proc. 2003-61, relief is subject to the following limitation: If the IRS adjusts the return to reflect an understatement of tax, relief will be available only to the extent of the liability shown on the return prior to any such adjustment

c. Equitable relief factors. A requesting spouse who does not satisfy the conditions for the "safe harbor" still may be eligible for full or partial relief. Several factors are listed in both Rev. Proc. 2000-15 and Rev. Proc. 2003-61

F. Tax Court Jurisdiction

1. When IRC Section 6015 was enacted, the Code expressly gave the Tax Court jurisdiction to review determinations by the IRS regarding traditional relief under IRC Section 6015(b) and the separate liability election under IRC Section 6015(c), but was silent as to IRC Section 6015(f). The wording of the latter provision—the IRS "may relieve" an individual of liability where

not doing so would be inequitable—and the fact that jurisdiction was expressly granted for IRC Sections 6015(b) and (c) but not (f), led many to believe that IRC Section 6015(f) was intended to be a completely discretionary tool for the IRS, not subject to Tax Court review

2. This view did not last long. In *Butler*, 114 TC 276 (2000), the Tax Court held that it had the jurisdiction to review the IRS' determination of equitable relief in deficiency cases, provided it had jurisdiction under IRC Section 6015(b) or (c). The Tax Court later clarified that rule in *Ferrarese*, TC Memo 2002-249, RIA TC Memo ¶2002-249, 84 CCH TCM 400, in which it determined that it could also review IRC Section 6015(f) determinations in "stand alone cases." In so doing, the Tax Court established that it could review determinations where there is no deficiency but an underpayment of taxes reported on the return

IV. Exemptions for Dependants

A. Generally, a child is a dependent of the parent who has custody of the child

B. Except if custodial parent signs an Agreement stating that he or she will not claim the children as a dependent. The non-custodial parent must attach the Agreement to his or her return

C. The general rule is that the custodial parent is the parent with whom the child lived for the greatest number of nights during the year

D. If a child is absent from the home, the child is treated as living with parent he or she would normally stay with

E. If a child stays with each parent an equal amount of time, the parent with the highest gross income is treated as the custodial parent

V. Alimony (IRC Section 71 and IRC Section 215)

A. Alimony is always reported as income by the recipient and deducted by the payer. If a payment is not alimony, it is neither income to the recipient nor deductible by the payer. See Page 1 of Form 1040 at Exhibit C and Page 1 of Form NJ-1040 at Exhibit D

1. To qualify for alimony the payment must be in cash and must be made pursuant to a divorce or separate maintenance decree or other written instrument

2. **Example 1. H and W are separated and in the process of getting a divorce. H voluntarily pays W $5,000 a month as temporary payments. If there is no underlying written document, the $5,000 payment is not alimony. The solution to this problem is simple. H's tax advisor should ask H's attorney to draft a written instrument to cover "temporary alimony" payments that will be in effect until a final agreement is reached. Both H and W must sign the agreement. Alternatively, H could get an interlocutory decree or a pendent elite**

3. Payment of cash can be made to a third party if

    a. The payment is in lieu of alimony

    b. Both spouses intend that payments are to be treated as alimony

    c. Written request is received before the spouse making payment files his or her return for the year of the payment

4. **Example 2. W and H are divorced and under the terms of the divorce decree, H is allowed to live in a home owned exclusively by W. W makes all payments with respect to the house. W's payments are not alimony and she may not deduct the payments as alimony (interest and property taxes may be deducted under other tax laws), and H is not required to report any of W's payments as alimony**

5. **Example 3. W transferred a house she owned to H as part of a divorce decree. H has written W and asked her to pay all principal, interest, taxes and insurance that H now owes on the house to Bank. Both parties agree to have the payments treated as alimony. W's payments to Bank will be treated as alimony – taxable to H and deducted by W – so long as W receives this request before she files her income tax return for the year the payments were made**

6. A payment that normally would be alimony can be designated otherwise, but payments that are not alimony cannot be treated as alimony

7. **Example 4. H and W are in the process of getting a divorce. W is asking for $10,000 a month as alimony payments, but H will not agree. As a compromise, W agrees to accept $7,500 a month, but insists that H sign a statement stating the payments**

will not be treated as alimony – not taxed to her or deducted by H. This is permissible. If the payee spouse wants to exclude an alimony payments, the payee must attach a copy of the instrument designating a cash payment as not alimony

8. **Example 5. H and W are in the process of getting a divorce. H wants to transfer an annuity contract to W in lieu of alimony and asks W to agree to treat the annuity contract as alimony – taxed to her and deducted by H. This is not permissible**

9. Alimony is not allowed if the divorcing couple still files a joint return

10. The alimony rules do not apply if a couple who is legally separated or divorced are members of the same household

11. Cash payment of alimony cannot be required to be made after the death of the payee spouse

12. **Example 6. W and H are divorced. According to the divorce decree, W is required to pay the mortgage on a house owned by H and such payment will continue to be made until such mortgage is paid. If H were to die before the mortgage is paid, W is liable to continue to make payments. None of the payments are treated as alimony. On the other hand, if the decree were to say that W is obligated to make the mortgage payments until the mortgage is paid or H dies, whichever first occurs, W's liability would end at H's death and the alimony rules apply. H would include the mortgage payments as income and W would deduct the payments**

13. Alimony is one of the few deductions allowed for New Jersey Gross Income Tax purposes

14. See Exhibit E for Alimony Schematic

B. Recapture

1. If a client's alimony payments decline or terminate during the first three calendar years, the client may be subject to certain recapture rules

2. According to the recapture rules, the payor may have to include alimony in income during the third year and the payee may be able to deduct alimony previously included

3. Reductions in alimony that may cause recapture include, but are not limited to, the following:

   a. A change in the client's divorce or separation instrument

   b. A failure to make timely payments

   c. A reduction in the payor's ability to provide support

   d. A reduction in the payee's support needs

4. Events that will not trigger the recapture rules and should be ignored include:

   a. Payments made under a temporary support order

   b. Payments made over a period of more than three calendar years that vary because they are a fixed part of the payor's income from a business or property, or are from the payor's employment or self-employment compensation

   c. Payments that decrease because of the death of either souse or the remarriage of the payee spouse before the end of the third year

5. The recapture rule is set forth in IRC Section 71(f), copy of which is attached at Exhibit F

6. **Example 7. H is required to pay W $50,000 in alimony in the first year, $39,000 in the second year, and $28,000 in the third year. $1,500 is recaptured in the third year as illustrated in the worksheet in Exhibit G**

IV. Child Support

A. Child support payments are not treated as alimony and may not be deducted or included as income

B. If both alimony and child support are required and the payer spouse misses payments, the first payments made are allocated to child support until all past due debt is paid in full

C. **Example 8. W and H are divorced. H is required to pay $5,000 a month in alimony and $2,000 a month in child support for a total of $84,000 a year ($60,000 alimony and $24,000 child support). H made**

$65,000 total payments for the current year: $24,000 is treated as child support and only $41,000 is treated as alimony

D. Child support payments must be specifically designated to eliminate taxation as alimony

1. Separate the alimony and child support as dollar amounts

2. Separate a percentage allocation between alimony and child support

3. Designate a payment that is reduced upon an exit event relating to children

a. Employment

b. Death

c. Leaving household

d. Leaving School

e. Marrying

f. Reaching a specific age

E. Exemptions to the rule are

1. Payments are reduced not more than six months before or after child reaches 18, 21 or the legal age of majority

2. Payments are reduced on two or more occasions and that each occurs not more than one year before or after a different one of the children reaches a certain age from 18 to 24. Must be same age for each child

VI. IRC Section 1041 Transfers in Settlement of Marital Property Rights

A. IRC Section 1041 provides that no gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of):

1. a spouse, or

2. a former spouse, but only if the transfer is "incident to a divorce." "Incident to a divorce" is where the transfer occurs within one year

after the marriage ceases, or is related to the cessation of the marriage

B. A transfer under IRC Section 1041 is treated as a gift, and the transferee takes the basis of the transferor

C. Impact of IRC Section 1041 on transfer of family business in divorce.

1. When the divorcing parties' assets are tied up in a family business, a method of dividing the marital property by taking into consideration the value of the family business will be required. IRC Section 1041 permits the transfer of a portion of the business to the spouse tax-free in exchange for a portion of his or her rights in the marital assets. Once he or she has the interest in the business, he or she is likely to want to sell it, and the likely purchaser is the business itself. The tax results may be remarkably different based on the facts

a. The spouse active in the business who makes payments to a former spouse may want a tax deduction for those payments on the basis that the payments were alimony, which would be taxable to the recipient (transferee)

b. On the other hand, if the spouse active in the business makes payments and receives stock which the former spouse held, the former spouse would like to take the position that the payments received and the stock transferred to the corporation or the former spouse constituted tax-free IRC Section 1041 transfers

2. The tax issues are whether the payments to the former spouse from the corporation are a redemption, which qualifies as a capital gain (or even a tax-free redemption), or a dividend. These two scenarios may have divergent tax results. The rules to determine whether the transfer and sale back to the corporation is a redemption, a dividend, or a tax-free IRC Section 1041 transfer can be complex

a. A redemption will mean that the corporation is purchasing the stock with after-tax dollars, perhaps 34%, and the former spouse may report a dividend or a capital gain at a 15% rate, for a combined effect of 49%

b. Or the purchase may be taxable as a constructive dividend if it is determined that the spouse who remained active or kept the business had a "primary and unconditional

obligation" to purchase the former spouse's interest

c. On the other hand, the former spouse who remains an active shareholder in the business may have no tax on the transfer of stock pursuant to IRC Section 1041

3. Capital Gains will be preferable to dividends. A capital gain will likely be preferable, because a capital gain may be offset by capital losses or a high basis of the stock redeemed due to a carryover basis. A qualified dividend is taxable at 15% regardless of other capital losses or tax basis. Therefore, whether the purchase of stock by the corporation qualifies as a redemption under IRC Section 302, rather than a dividend, may still be quite important. But, qualifying as a redemption may be quite difficult in the family business situation

   a. Timing may be very important, because after the divorce there would not be family attribution to the former husband, but a redemption just prior to the divorce would have the redeemed shareholder deemed to still own stock held by her husband prior to the divorce

   b. The redeemed shareholder may still have attribution to her children if they are shareholders

4. The transferee who remains an active shareholder will want to claim that a transfer of the stock received is tax-free pursuant to IRC Section 1041. If the former spouse sells the stock, pursuant to a divorce, to the corporation, she will want to be certain that the sale is not treated as a dividend, but is rather treated as an IRC Section 302(b) redemption at worst

5. The Two Ames Cases and IRC Section 1041 illustrated the opportunity that existed to whipsaw the IRS, and explains why Reg. Sec. 1.1041-2 was necessary

   a. John and JoAnn Ames were the joint and sole shareholders in a corporation which operated a McDonald's franchise. The franchise agreement required that only owner-operators could own the stock of the franchise, and, therefore, when the Ames decided to divorce, one of the spouses was required to transfer his or her interest in order to retain the McDonald's franchise. It was agreed that Mr. Ames, as part of a written property settlement, would have the corporation redeem Mrs. Ames' 50% interest in the company for $450,000, which was to be paid primarily as

an installment obligation from the corporation over a 10-year period. Mrs. Ames' basis in her stock was only $2,500. Mr. and Mrs. Ames entered into a divorce decree in January 1988, and shortly thereafter her stock certificate was canceled and the same number of shares was issued to Mr. Ames

b. The First Ames Case. Mrs. Ames initially reported the redemption as a long-term capital gain under IRC Section 302(b)(3), but the following year, she filed a claim for refund for the amount of taxes previously paid and alleged that the cash payment from the corporation was in exchange for her stock in a tax-free transfer under IRC Section 1041. The IRS denied Mrs. Ames' claim for refund, and she filed a refund suit in the District Court in Washington. The District Court held that Mrs. Ames was not taxable because the buyout was required by the divorce decree. The Court found that Mr. Ames was primarily liable to make the payment for Mrs. Ames' stock and that the stock was redeemed at his direction in Ames #1. The 9th Circuit Court of Appeals affirmed the District Court at *JoAnn C. Ames v. U.S.*, 981 F.2d 456 (9th Cir. 1992), finding in substance that Mrs. Ames was not taxable

c. The Second Ames Case. In order to avoid being whipsawed prior to the 9th Circuit's decision in Ames #1, the IRS asserted that Mr. Ames, in fact, had obtained his wife's stock in an IRC Section 1041 transfer and then caused such shares of stock to be redeemed, which resulted in a constructive dividend to him. The case came before the Tax Court in Ames #2, *John A. Ames v. Comm.*, 102 TC 522 (1994), which found that Mr. Ames had only guaranteed the obligation of the corporation to redeem his wife's stock, but that he did not have a "primary and unconditional obligation" to purchase his wife's stock, and, therefore, the transaction was not a constructive dividend to Mr. Ames

d. The planning opportunity that existed prior to the final IRC Section 1041 revisions still exists, but not the opportunity to whipsaw the IRS. The important point of these cases is to show that a husband and wife, in connection with a divorce, could structure the transaction to end up with the most favorable tax outcome for both parties, but they must now take consistent positions to keep from whipsawing the IRS

e. The IRS first issued temporary Reg. Sec. 1.1041-1T dealing with the treatment of the transfer of property between spouses or incident to a divorce in the form of questions and answers, and then issued final Reg. Sec. 1.1041-2 in January 2003 to keep from being whipsawed, as had happened in the two Ames cases. If this regulation applies, the transfer to the company is treated first as an IRC Section 1041 transfer to the husband and then as an immediate transfer by the husband to the Company in a transaction not governed by IRC Section 1041. For example, where a wife transfers stock to a corporation which redeemed that stock, the husband indirectly enjoyed an increased percentage of ownership in the company. The question of how the IRC Section 1041 regulations applied in the context of redemptions was the source of much confusion and litigation prior to new IRC Section 1041 regulations

6. The Final Regulations on the treatment of redemptions of stock were issued as Reg. Sec. 1.1041-2

a. The final regulations provide that in a transaction where a corporation redeems stock owned by a wife, and the wife receives property in such redemption, which is not treated as resulting in a constructive distribution to the husband, then the form of the stock redemption will be respected for federal income tax purposes. Therefore, the wife cannot contend that the transfer is tax-free under IRC Section 1041, but rather the rules of IRC Section 302 will apply

b. The final regulations also provide, in essence, that if a corporation redeems stock owned by a wife, and the wife's receipt of property in respect of such redeemed stock is treated as a constructive distribution to the husband, then the redeemed stock shall be deemed first to be transferred by the wife to the husband and then to be transferred by the husband to the redeeming corporation. Any property actually received by the wife from the redeeming corporation in respect of the redeemed stock shall be deemed (1) first to be transferred by the corporation to the husband in redemption of such spouse's stock, and then (2) to be transferred by the husband to the wife. Accordingly, IRC Section 1041 can apply to any deemed transfer of the stock and redemption proceeds between the husband and the wife, provided that the requirements of IRC Section

1041 are otherwise satisfied with respect to such deemed transfer. IRC Section 1041, however, will not apply to any deemed transfer of stock by the husband to the redeeming corporation in exchange for the redemption proceeds

c. The final regulations provide that the spouses or former spouses can make an agreement between themselves as to how the transaction will be taxed. This agreement can be in a divorce or separation instrument, or a valid written agreement between the parties, which supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock. If both parties intend for the redemption to be treated, for federal income tax purposes, as a redemption distribution to the transferor spouse, that will be honored. On the other hand, if the parties intend for the redemption to be treated as a constructive distribution to the husband, they can so agree. For the agreement to be effective, it must be filed with the applicable federal income tax return for the year that includes the date of the stock redemption, but no later than the date such return is due (including extensions)

D. Impact of IRC Section 1041 on Transfer of Family Residence

1. IRC Section 121 sets forth rules which allow qualifying taxpayers (regardless of age) to exclude from gross income gain of up to $250,000 ($500,000 for certain qualifying joint filers) realized on a sale of their principal residence once every two years

2. To exclude gain under IRC Section 121 (subject to certain limited exceptions), a taxpayer must satisfy the following requirements:

a. The taxpayer (or, if married taxpayers file a joint return in the year of sale, his or her spouse) has owned and used the home as his or her principal residence for periods aggregating two of the five years immediately prior to the sale

b. The taxpayer has not excluded gain under IRC Section 121 with respect to a sale occurring within the two years immediately preceding the current sale

3. IRS Section 121 does not define “principal residence” but regulations issued in December 2002 adopt a facts and circumstances test to determine a taxpayer’s principal residence

4. IRC Section 121(a) imposes both ownership and use requirements

   a. The taxpayer must have owned and used the home as his or her principal residence for periods (not necessarily continuous) aggregating two of the five years immediately prior to the sale

   b. If married taxpayers file a joint return in the year of sale, according to Section 121(d)(1), either spouse's ownership and use of the home may satisfy these requirements

      (i) Taxpayers who are married on the first day of the tax year but are legally separated under a decree of divorce or separate maintenance on the last day of the tax year cannot file a joint return, Reg. Sec. 1.6013.4

      (ii) Even though a husband and wife are not living together on the last day of the tax year, if they are not divorced or legally separated, they may still file a joint return

      (iii) A married couple can change from separate return filing to a joint return. IRC Section 6013(b)(2). However, once a joint return has been filed, the spouses may not thereafter file separate returns unless the time for filing the return of either spouse has not expired. Reg. Sec. 1.6013-1(a)

   c. IRC Section 121(d)(3) contains two special rules applicable to separated and divorced taxpayers selling a principal residence

      (i) If the selling taxpayer previously obtained the home from his or her spouse or former spouse in an IRC Section 1041 transaction, the taxpayer's holding period with respect to such property includes the period his or her spouse or former spouse owned the property

      (ii) If one spouse or former spouse is granted use of the home under a divorce instrument described in IRC Section 71(b)(2), that occupant spouse's use of the property as his or her principal residence during the occupancy period granted by the instrument is imputed to the other spouse. A spouse's sole use of

the marital home prior to entry or execution of the divorce instrument is not imputed to the nonoccupant spouse for purposes of IRC Section 121(a) or Section 121(b)(2). Thus, the timing of a spouse's departure from the marital home could be strategic from the standpoint of IRC Section 121, depending on how long he or she has already lived in the house and how long after the entry or execution of the instrument the parties intend to sell the home

(iii) "Divorce instruments" under IRC Section 71(b)(2) include decrees of divorce or separate maintenance, instruments incident to a decree of divorce or separate maintenance, written separation agreements, and support orders

VI. Divorce and its Effect upon Retirement Plan Benefits

A. Spousal Consent to Waive Interest in Qualified Retirement Plan Benefits

1. Once the parties are married, it is possible to have the spouse consent in writing to waive any interest in the qualified retirement plan benefits of the participating spouse

2. Although a Prenuptial Agreement can contractually obligate the future spouse to sign such a consent, if the consent is not signed after the actual marriage, it is invalid under ERISA and Retirement Equity Act. Reg. Sec. 1.401 (a) 20, Q&A 28

B. Retirement Plan QDROs

1. The ability of divorcing spouses to make a division of their property through an assignment of the participating spouse's IRA or a Qualified Domestic Relations Order (QDRO) is a tremendous planning opportunity

2. A QDRO will allow the participating spouse to transfer some of such spouse's most liquid and significant assets, qualified retirement plan funds, to the former spouse. This tax-free division of property shifts ordinary income assets, including the tax burden, to the former spouse

3. The QDRO can be segregated as a separate account of the company's plan or rolled over by the former spouse into such spouse's own individual retirement account, which will allow such

spouse to control the assets and totally separate them from the participating spouse

4. The former spouse receiving the retirement plan proceeds can continue to defer the tax on the transferred retirement plan, or withdraw a portion of the money to meet such spouse's immediate cash needs without a 10% early withdrawal penalty

5. The technical requirements for a QDRO are very significant and must be followed exactly for the distribution to qualify as a tax-free transfer of the retirement funds to the former spouse as the "alternate payee"

   a. The rollover must be pursuant to a qualified domestic relations order

      (i) The QDRO must be pursuant to a signed order of the Court at or about the time the divorce or Property Settlement Agreement is approved. If the rollover is not made pursuant to a qualified QDRO, it may still be an enforceable obligation to roll over funds to the alternate payee. Under these circumstances, the funds would be taxable to the remaining spouse

      (ii) Once the order has been entered and the payments made, it is too late to recall the transaction to correct the tax effect

   b. The plan must authorize, or be amended to authorize, immediate distribution where the plan would otherwise require an employee to wait until retirement to obtain a distribution

   c. The plan must provide for a plan-to-plan transfer in order for the QDRO to be rolled over directly to an IRA. If it does not provide for this, then the payment of the qualified plan proceeds would be subject to a 20% withholding tax

C. Even an assignment of an IRA requires a signed court order, although not the formal requirements of a QDRO. Otherwise, the assignor will be taxed on the distribution and will receive a Form 1099R from the IRA custodian (IRC Sections 71 (b)(2)(A) and 408(d)(6))

D. Possibility of Property Settlement Agreement (PSA) as QDRO

1. In the event a formal QDRO is not executed by the parties to a divorce, the Courts have held that the PSA may qualify as a QDRO

2. As discussed in *Ross v. Ross*, 308 N.J. Super. 132 (App. 1998), where the participating spouse died before the QDRO was finalized, in order for the PSA to qualify, it must have sufficient specificity regarding the retirement assets covered.

a. In *Ross*, the court held that the PSA was specific enough with respect to only some of the decedent's retirement plan assets. Where the PSA specifically (i) identified the retirement plans to which the PSA applied, (ii) named the former spouse as payee, (iii) set forth the percent of the retirement plan to which the PSA applied and (iv) the number of plan payments to which the PSA applied, the PSA was a QDRO and the retirement assets were subject to the PSA

b. However, those plans that were not specifically referred to in the PSA were not deemed to be subject to the PSA

E. Attached hereto as Exhibit H is an example of a QDRO

VII. Effect of Divorce upon Existing Estate Plans under the Revised New Jersey Probate Code

A. N.J.S.A. 3B:3-14 covers probate and non-probate transfers in the context of divorce or annulment

1. Under prior law, divorce or annulment occurring after the execution of a Will revokes: (a) any dispositions or appointments of property by the Will to the former spouse; (b) any general or special power of appointment conferred on the former spouse; and (c) any fiduciary appointment of the former spouse, unless the Will expressly provides otherwise

2. Under the Revised New Jersey Probate Code (the "Act"), effective February 27, 2005, these provisions will also apply to the relatives of the former spouse. Furthermore, these provisions will also apply to non-probate transfers

B. The revisions introduce the term "Governing Instrument" to reach beyond the Will

1. This new provision serves to codify, in part, the ruling in *Vasconi v. Guardian Life Insurance Co.*, 124 N.J. 338 (1991), which held that a Property Settlement Agreement presumptively revokes non-probate transfer of insurance proceeds

2. *Governing Instrument* was added to mean a deed, Will, revocable trust, insurance or annuity policy, account with the designation "pay on death" or "transfer on death", security registered in beneficiary form with the designation "pay on death" or "transfer on death," pension, profit-sharing, retirement or similar benefit plan, instrument creating or exercising a power of appointment or power of attorney, or a dispositive, appointive or nominative instrument of any similar type. Addition of this term recognized the fact that many types of transfers take place at death in non-testamentary instruments

C. Unless otherwise provided for expressly in the terms of a governing instrument, a court order, or a contract relating to the division of the marital estate made between divorced individuals before or after the marriage, divorce or annulment, a divorce or annulment revokes any revocable disposition or appointment of property made by a divorced individual to a former spouse in a governing instrument and any disposition or appointment created by law or in a governing instrument to a relative of the divorced individual's former spouse

D. Fiduciary or representative appointments are also revoked for the same class of people

E. Upon divorce or annulment, all provisions are given effect as if they were disclaimed by the former spouse and relatives of the former spouse. Fiduciary or representative appointments are given effect as if these individuals died immediately before the divorce or annulment

F. Any interest of a former spouse held as joint tenants with rights of survivorship or as tenancy by the entirety are severed, transforming the interests into tenants in common. Any third party relying on the representations made by one party and purchasing the property will not be adversely affected by this statute. The spouse ignoring this statute and misleading a purchaser will be liable to the other spouse for the damage

G. The attorney must consider those divorced persons who still want to name certain of these individuals as guardians or provide for them in their estate plan. The governing instrument must specifically address the statute and opt out of it for purposes of providing for these individuals. Therefore, in

these unique situations, the divorced individual should execute a governing instrument subsequent to the divorce or annulment

VIII. The New Jersey Spouse's Elective Share

A. The Elective Share Statute, N.J.S.A. 3B:8-1 et seq., was enacted in 1979, to become effective on May 28, 1980. If a married person dies domiciled in New Jersey, his or her surviving spouse has a right to elect to take one-third (1/3) of the "augmented estate," subject to statutory requirements. The statute denies an elective share to a surviving spouse where the spouse had been living separate and apart under circumstances which would have given rise to a cause of action for divorce or nullity of marriage to a decedent prior to his or her death under the laws of the State of New Jersey. N.J.S.A. 3B: 8-1

B. Prior History

1. Until 1980, New Jersey was one of the few states without a statute providing an elective share for a surviving spouse

2. Surviving spouses relied upon rights of dower and courtesy, which ran only to rights in real property. These rights were easily defeated by the creation of corporations to hold real estate

C. In 2005, N.J.S.A. 3B:8-1 et seq. was amended to also apply to domestic partners

D. The Augmented Estate

1. Meaning of "Augmented Estate" is set forth at N.J.S.A. 3B:8-3. The statute defines the augmented estate as the estate reduced by funeral and administration expenses, and enforceable claims. The statute proceeds to add the value of property transferred by the decedent at any time during the marriage, to or for the benefit of any person other than the surviving spouse, to the extent the decedent did not receive adequate and full consideration for the transfers if such transfer falls within the following definitions:

a. A transfer where decedent retained, at the time of his or her death, the possession or enjoyment of or right to income from, the property. Examples include grantor trusts with retained rights to income or principal, life estates, annuities (private or otherwise), GRITs, GRATs or GRUTs

b. A transfer where decedent retained at the time of his or her death a power, either alone or in conjunction with any other

person, to revoke or to consume, invade or dispose of the principal for his or her own benefit. Examples include decedent-created revocable or living trusts

c. Any transfer whereby property is held at the time of decedent's death by decedent and another with a right of survivorship. Examples include joint bank accounts with right of survivorship, commonly designated as "or" accounts and real property held as joint tenants with right of survivorship

d. Any transfer, if made within two (2) years of the death of the decedent, to the extent that the aggregate transfers to any one donee in either of the years exceed $3,000.00. Examples include annual exclusion gifts (outright) and Crummey power gifts

2. Certain transfers are excluded pursuant to N.J.S.A. 3B:8-5 such as transfers made with the written consent or joinder of the surviving spouse

3. The following property is also excluded from the augmented estate, pursuant to N.J.S.A. 3B:8-5, even though payable to a person other than the surviving spouse:

a. Proceeds of life insurance policies owned by the decedent

b. Proceeds of accident insurance

c. Proceeds of joint annuity or pension

4. Property to be included in the augmented estate, pursuant to N.J.S.A. 3B:8-6, includes:

a. The value of property owned by the surviving spouse at the time of, or as a result of, the decedent's death to the extent that the property was derived from the decedent by means other than by testate or intestate succession without full consideration in money or money's worth. Examples include gifts to surviving spouse by decedent during his or her lifetime

b. The value of property transferred by the surviving spouse at any time during the marriage without full consideration to any person other than the decedent which would have been includable in the spouse's augmented estate had he or she

predeceased the decedent

5. Valuing Property Transferred – N.J.S.A. 3B:8-4, *In re Estate of Cole*, 200 N.J.Super, 396, 491 A.2d 770 (Ch. Div. 1984)

   a. The statute provides that the property referred to in N.J.S.A. 3B:8-3 is to be valued as of the decedent's date of death with the exception that property irrevocably given to a donee during the decedent's lifetime is valued as of the date the donee came into possession or enjoyment of the property if that occurs first. The above refers to nonprobate or predeath transfers

   b. As to property in the hands of the executor, different rules pertain. An important decision in the area was rendered by Judge Richard Cohen in 1984. *In re Estate of Cole* contains a considerable discussion of the history and manner of providing for an elective share. The issues of the case revolve around the proper date and manner of valuation of the estate and elective share, the disposition of realized gains and losses during administration, the right of the surviving spouse to a portion of estate income before distribution, and the assessability of the elective share for estate and inheritance taxes. *In re Estate of Cole* held as follows:

      (i) The elective share is satisfied first out of the survivor's assets and out of the decedent's bequests and nonprobate transfers to him or her. If insufficient, the balance is equitably apportioned among the recipients of the augmented estate in proportion to the value of their interest therein. N.J.S.A. 3B:8-18(c)

      (ii) Judge Cohen reasoned that the elective share should be computed as a fractional share, not a pecuniary share. This rule pertains to the residuary probate estate. Judge Cohen further held that the surviving spouse's assets should be valued as of the date of death

      (iii) As to income earned in the estate, the Court held that the spouse has the right to a fractional share of income earned by the estate equal to the portion of the corpus of the estate which he or she is entitled to take

(iv) The Court looked to the testator's intent, as expressed by the terms of his or her Will, when determining that the spouse's elective share would pass free of tax to the widow(er)

6. Valuing Property Transferred in Trust or via Life Estate N.J.S.A. 3B-8-17

a. The statute provides that the electing spouse's total or proportional beneficial interest in any trust shall be valued at one-half of the total value of the property or trust or of the portion of the property or trust subject to a life estate

b. The above rule allows for creation of life estates by decedents as well as qualified terminable interest property ("QTIP") trusts to satisfy the elective share

E. How to Elect Against the Estate

1. Election is made by filing a Superior Court Complaint in the county in which the personal representative was appointed within six months (which may be extended by the Court) of the appointment of a personal representative for the estate. See N.J.S.A. 3B:8-12. The time period may be extended upon showing of good cause by the surviving spouse, provided the order extending the time is entered before the time for election has expired, and proper notice is given to all parties affected. *McKay v. McKay's Estate*, 184 N.J. Super 217, 445 A.2d 473 (Law Div. 1982), affirmed 188 N.J. Super 44, 455 A.2d 1142 (App. Div. 1983) held that the statute should not be treated as any other statute of limitations and therefore should be waived under the circumstance presented

2. The right of election is personal to the surviving spouse. N.J.S.A. 3B:8-11. The right of election cannot be exercised by an Executor. However, the right of election may be exercised by a guardian appointed for the surviving spouse, upon a finding that such election is necessary to provide adequate support for the surviving spouse during his or her probable life expectancy

3. N.J.S.A. 3B:8-14 provides that the surviving spouse may withdraw his or her demand for an elective share at any time before entry of a final judgment by the court. Consider filing a protective election on behalf of the spouse where you are unsure as to entitlement to an elective share

F. Waiver of Right to Elect Against Estate

1. N.J.S.A. 3B:8-10 permits a spouse or prospective spouse to waive the right to elect by written agreement made before or after the marriage after fair disclosure. Note that the law requires full disclosure in the case of enforcement of antenuptial agreements. See *D'Onofrio v. D'Onofrio*, 200 N.J. Super. 361, 491 A.2d 752 (App. Div. 1985); *Marschall v. Marschall*, 195 N.J. Super. 16, 477 A.2d 833 (Ch. Div. 1984)

2. A waiver of "all rights" in the property or estate of a present or prospective spouse, or a complete property settlement agreement entered into by the parties after or in anticipation of separation or divorce, should constitute a waiver of elective share by each spouse

IX. Divorce and the Use of Trusts

A. The Irrevocable Life Insurance Trust

1. See attached Memorandum at Exhibit I

2. See attached Withdrawal Notice at Exhibit J

B. Divorce Settlement Trust (Alimony Trust)

1. An Alimony Trust is a useful vehicle to provide a guaranteed source of support to a divorced spouse rather than depending on the payor's unfunded promise to pay.

   a. For instance, rather than making outright payments of alimony, the obligor spouse transfers cash or other income producing property into an irrevocable trust established for the benefit of the obligee spouse in exchange for his or her release of future support rights

   b. The amount of the property transferred into trust may be equal to the present value of the support rights released (i.e., the total amount of alimony which would have been paid based on actual payments, if the alimony would have been rehabilitative alimony, or based on actuarial calculations if the alimony is indefinite or permanent).

   c. The trust continues for the same period that the support would have been payable, after which, the trust terminates

and the remaining trust estate reverts to the settlor or to settlor's estate or the settlor's children.

2. The trustee of the trust may be the settlor or an independent third party. The divorced spouse, of course, prefers an independent third party.

   a. The trustee has a fiduciary duty to the beneficiary to distribute the trust income in accordance with the trust agreement and to invest, conserve and manage the trust principal.

   b. **Example 9. H and W are separated under a written separation agreement. A settlement trust provides that W is to receive payments of $12,000 annually in exchange for W's release of future spousal support. H transfers $100,000 in stock to the trust. During the first year the trust earns $11,000 in dividends on the stock and W receives a $12,000 distribution from the trust. (The additional $1,000 is treated as a distribution of principal.) The trust reports $11,000 in income and deducts $11,000 for the distribution. W must report only $11,000 in income. See IRC Section 682(a). During the second year the trust earns $12,500 in dividends, and W receives a $12,000 distribution. The trust reports $12,500 in income and deducts only $12,000. W must report $12,000 in income. The trust must recognize $500 of income**

   c. **Example 10. If, in the above Example 9, a portion of the $12,000 is allocable to child support, that portion will be taxable to the settlor (rather than to the distributee) under §§677(b) and 682**

   d. **Example 11. H transfers $100,000 in tax-free municipal bonds to a trust with the direction that all interest is to be distributed to W. During the first year, the trust earns $8,000 of tax-free interest. Even though W has $8,000 of interest, it retains its tax free character so that W has no income to report upon the receipt of the distribution. The trust reports no income and takes no deduction**

C. Other Trusts created pursuant to Settlement of Divorce

X. Divorce and its Effect upon Estate Planning

A. Estate planning for persons involved in multiple marriages is generally more complex and involved than estate planning for a couple in a first marriage

1. The parties may have children from a prior marriage or marriages and must weigh the interests of their issue with those of their current spouse. Estate tax implications further complicate the planning process in 2012 since a bequest in excess of $5,120,000 to issue will create federal estate tax, a result which can be avoided by utilization of the marital deduction. However, a QTIP Trust for the surviving spouse may not be practical since the surviving spouse may not be much older than the children and the children will have to wait for the death of the surviving spouse to vest in the remainder of the QTIP Trust, if any

2. Planning for persons with multiple marriages is burdened by various potential contractual obligations such as Prenuptial Agreements between the parties and Property Settlement Agreement(s)

3. Often the contractual obligations of Prenuptial Agreements and Property Settlement Agreements require specific ownership and beneficiary designations of life insurance and beneficiary designations of retirement plans which require counsel to orchestrate these changes

B. The tax and estate planning attorney representing persons involved in multiple marriages must be sensitive to the minefield of contractual obligations and restrictions which counsel must navigate