

Planning Considerations For When The Marriage Or Domestic Relationship Dissolves

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AEP - Accredited Estate Planner

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PLANNING CONSIDERATIONS FOR WHEN THE MARRIAGE OR DOMESTIC RELATIONSHIP DISSOLVES

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INTRODUCTION

- FIVE (5) TOPICS OF DISCUSSION
 - Pre-marital and post-marital agreements
 - Selected tax issues
 - Planning in advance of marital dissolution
 - Dissolution of domestic relationships
 - Dissolution of the family business

Introduction – cont.

- REMEMBER:
 - Comprehensive wealth transfer and asset protection planning requires the sophisticated integration of:
 - Tax law – both state and federal
 - Income tax
 - Never forget this important issue when planning an estate
 - Gift tax
 - Estate tax
 - GSTT

Introduction – cont.

- Comprehensive integrated planning – cont.
 - State property and family law
 - Wills, trusts and distribution standards
 - Marital agreements
 - Asset protection planning
 - Business organization and reorganization

Introduction – cont.

- **REMEMBER** – cont.
 - Comprehensive wealth transfer and asset protection planning combines:
 - Accumulation
 - Preservation
 - Distribution

PRE –MARITAL AND POST-MARITAL AGREEMENTS

Marital Agreements

- Types of Marital Agreements
 - Pre-marital agreements
 - Post-marital agreements
 - Separation agreements
- Purposes of Marital Agreements
 - Protection of assets in the event of divorce
 - Protection of assets in the event of death
 - Delineate obligations during marriage

Requirements of Marital Agreements

- The Uniform Premarital Agreement Act – “UPAA” – Sec. 6(a)
 - Complete financial disclosure
 - Assets, liabilities and income
 - Details regarding value
 - Circumstances when financial disclosure is unnecessary

Requirements – cont.

- The requirement of “consideration”
 - UPAA Sec. 2 – enforceable without consideration
 - State statutes and case law
- Formalities of execution
 - UPAA Sec. 2
 - It must be in writing and signed by both parties

Requirements – cont.

- Waiver of alimony and spousal support
 - UPAA Sec. 3(a)(4) – parties may contract with respect to modification or elimination of spousal support
 - State statutes and case law
- No waiver of child support, custody and visitation
 - UPAA
 - State statutes and case law
 - These provisions should not be included in a marital agreement

Requirements – cont.

- Waiver of equitable distribution of property and interest in marital earnings and appreciation of separate property
 - UPAA – generally enforceable
 - State statutes and case law – generally enforceable
- Waiver of interest in homestead property
 - Generally enforceable

Requirements – cont.

- Waiver of interests in retirement plans
 - Consult both federal and state law
 - ERISA – The Employee Retirement Income Security Act of 1974
 - REA – The Retirement Equity Act of 1984
 - The Internal Revenue Code of 1986, as amended (the "Code")
 - Secs. 401(a)(11) and 417

Requirements – cont.

- Waiver of rights upon death
 - State statutes and case law
 - Rights to elect against the will or any other instrument of the other party
 - Elective share rights
 - Rights as an intestate successor
 - Rights as a pretermitted spouse

Requirements – cont.

- Waiver of rights upon death – cont.
 - Exempt property rights
 - Family allowances
 - Homestead rights
 - Right to qualify and serve as a personal representative/executor or trustee
- Remember – waivers must be signed after the marriage
 - Otherwise they are not enforceable

Requirements – cont.

- Timing of execution
 - Before or after the marriage
- Fair and equitable under the circumstances
- No undue influence, duress, misrepresentations, fraud, etc
- Right to separate counsel

Requirements – cont.

- Conflicts resolution
 - Forum
 - Situs
 - Mediation
 - Arbitration
 - Collaborative initiatives

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SELECTED TAX ISSUES

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An Overview of Tax Issues

- Income tax issues
 - Income tax effect of payments of alimony – Sec. 71
 - Federal income tax returns
- Gift tax issues
 - Sec. 2512(b) – transfers for less than full and adequate consideration in money and money's worth
 - These are gifts

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Tax Issues – cont.

- Exceptions to the treatment of a transfer incident to a divorce as a gift
 - Sec. 2516 payments
 - A signed agreement within two years before or one year after the date of divorce
 - "Harris Rule" payments – payments pursuant to an agreement incorporated into a court decree or under a court order for divorce or support

Tax Issues – cont.

- Gift tax exceptions – cont.
 - Payments made in satisfaction of a legal obligation to support
 - Annual exclusion payments and qualified transfer for certain educational and medical expenses
 - Waivers of pension rights
 - Gift splitting

Income Tax Issues

- Property distributions – Sec. 1041
 - Transfers between spouses or former spouses incident to divorce are not taxable
 - "Incident to divorce" means that the transfer occurs within 1 year of the end of the marriage, or is related to the cessation of the marriage, or is within 6 years after the end of the marriage pursuant to a divorce or separation agreement

Income Tax Issues – cont.

- Property distributions – cont.
 - The six (6) year rule can be rebutted
 - Show that the property could not be transferred within 6 years because of factors such as valuation issues, legal issues or business reasons in the case of a closely held company
 - Consider using a "property settlement note" for the transfer of a large asset

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Income Tax Issues – cont.

- Property distributions – cont.
 - Types of property
 - Separate property
 - Marital property
 - Community property
 - AZ, CA, ID, LA, NV, NM, TX, WA and WI
 - Unsure

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Income Tax Issues – cont.

- Sec. 1041 traps for the unwary
 - The rules apply even if a divorce does not occur
 - The rules apply even for "arm's length transactions" for value between spouses
 - Transfers are treated as gifts with carryover basis

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Income Tax Issues – cont.

- Sec. 1041 traps for the unwary – cont.
 - Non-recognition rules do not apply to non-resident aliens
 - Since non-resident aliens would not have to pay U.S. tax on the sale of property outside of the country, they are not allowed to receive property tax-free in a divorce

Income Tax Issues – cont.

- Retirement plans – valuation
 - Defined contribution plans – account balance
 - Defined benefit plans – PV of future benefits
 - Coverture fraction:
 - # years married while a participant
 - # years of participation in the plan

Income Tax Issues – cont.

- Avoid 10% penalty on qualified plan distributions before age 59½
 - The distribution must be made directly to the non-employee spouse under a QDRO. Do not roll into an IRA and then distribute
- Remember – early distributions from IRAs are subject to the 10% penalty rule

Income Tax Issues – cont.

- E: Review the divorcing client's beneficiary designation forms
 - Beneficiary designation forms often do not get changed to reflect the changed circumstances of a divorce, even when estate planning documents are updated
 - Help your client set up a system to monitor a former spouse's beneficiary designations in cases where insurance policies or other assets will continue to benefit your client

Income Tax Issues – cont.

- E: Avoid transferring stock options
 - Transferring ISOs will convert long-term capital gain property into ordinary income property
 - Employee spouse holds the non-employee spouse's options until the date of exercise or sale, when a true fair market value is realized. Then the employee spouse transfers the non-employee's share less taxes

Income Tax Issues – cont.

- E: Alimony
 - Refer to alimony as spousal support
 - Tax effects of spousal support often are key to fair divorce settlements

Income Tax Issues – cont.

- Spousal support – cont.
 - Spousal support greater than \$15k/year must be paid for at least 3 years
 - Spousal support that decreases by more than \$15k in the first three years is subject to "alimony recapture"
 - Recaptured alimony is included in the payer's income in the third post-separation year

Income Tax Issues – cont.

- Do not reduce alimony at a time related to a child contingency
 - Even if the instrument is silent about specific child contingencies, you must be careful to avoid implicit relationships between reductions in support and children's ages
 - The contingency doesn't even have to occur to have support payments reclassified from alimony to child support

Income Tax Issues – cont.

- Child support
 - Child support guidelines are set by every state
 - High income clients are "off the chart"
 - Get expert advice to help calculate the "standard of living"

Income Tax Issues – cont.

- Other tax issues
 - Filing status
 - Dependency exemptions
 - Tax planning and projections

Income Tax Issues – cont.

- Both parents can file using head of household status
 - They each must provide a home for at least one child for over half the year
- The definitions of "qualifying child" and "dependent" are updated
 - The focus is on whether the dependent paid more than one half of his or her own support – rather than whether the parent paid more than one half of the child's support

Income Tax Issues – cont.

- Advise your clients not to specify that the higher earning spouse will claim the dependency exemption
 - The exemption and related credits may be completely lost due to AGI phase outs

Income Tax Issues – cont.

- Consider filing separate returns for divorcing couples
 - The innocent spouse rules have improved, but they still are not "easy." MFS is the best way to avoid the potential tax liabilities of an untrustworthy spouse.

Income Tax Issues – cont.

- Tax the "long view"
 - Look at long term consequences of a divorce transaction by doing projections, what-if scenarios, etc.
 - Avoid the temptation just to look at who gets what on day one of the divorce
- Keep in mind the extremely complicated tax issues involved with splitting up family owned businesses

PLANNING PRIOR TO DISSOLUTION OF THE MARRIAGE

Planning Prior to Dissolution of the Marriage

- Introduction
- Property settlement agreements
 - General aspects of property settlement agreements
 - Provisions to include in property settlement agreements
 - Asset division
 - Division of liabilities
 - Waiver of rights by a spouse in the event of the death of the other spouse
 - Tax issues

Planning Prior to Dissolution – cont.-

- Re-titling assets
 - The Uniform Probate Code – “UPC” – Sec. 2-804
 - Divorce severs interests of a former spouse in certain types of property
 - Joint tenancies
 - Tenancy by the entirety
 - Be careful of rights created as tenants in common

Planning Prior to Dissolution -cont.-

- Last Wills and Testaments – UPC Sec. 2-804
 - Draft new wills or codicil
 - Beneficial interests revoked and provide for new beneficiaries
 - UPC
 - State statutes and case law
 - Planning prior to divorce

Planning Prior to Dissolution -cont.-

- Last wills and testaments – cont.
 - Spouse as personal representative/executor
 - Spouse as guardian
 - Descendants of spouse

Planning Prior to Dissolution -cont.-

- Revocable trusts – UPC Sec. 2-804
 - Beneficial interests
 - UPC
 - State law
 - Planning for divorce
 - Spouse as trustee
 - Descendants of spouse

Planning Prior to Dissolution -cont.-

- Durable powers of attorney
- Health care powers of attorney
- Living wills
- HIPAA forms
- Irrevocable trusts
 - Ability to remove a former spouse (and descendants?) as:
 - Beneficiary
 - Trustee

**Planning Prior to Dissolution
-cont.-**

- Irrevocable trusts – cont.
 - Draft specific language dealing with the status of a former spouse
 - Special powers of appointment
 - Trustee removal powers
 - Trust protectors

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**Planning Prior to Dissolution
-cont.-**

- Beneficiary designations
 - Life insurance
 - Annuities
 - Retirement plans
 - ERISA
 - REA
 - IRAs
 - PODs and TODs

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**Planning Prior to Dissolution
-cont.-**

- Request parents and other potential donors and transferees to created dynasty/asset protection trusts
 - BDITs
 - Situs considerations
- Settlor self-settled trusts
 - Nevada
- Other asset protection entities
 - FLPs/FLLCs
 - Situs

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Planning Prior to Dissolution
-cont.-

- Elective share
 - UPC Secs. 2-202 to 2-209
 - Calculate the surviving spouse's elective share as a proportion of the decedent's augmented estate
 - Planning techniques
 - Create an entity such as a FLP or a FLLC
 - Watch the application of discounts

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Planning Prior to Dissolution
-cont.-

- Planning techniques – cont.
 - Include provisions in testamentary documents regarding satisfaction of the elective share
 - Include a provision that provides for the distribution of less desirable assets if the spouse elects against the original planning
 - Consider changing the state of residence

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Planning Prior to Dissolution
-cont.-

- The elective share under state law – state law specific
 - Definition
 - The surviving spouse of a person who dies domiciled in the state has the right to a specified share of the elective estate of the decedent

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Planning Prior to Dissolution -cont.-

- Categories of property that may be included in determining the elective estate:
 - Probate estate
 - Jointly held property
 - Revocable trusts and other revocable transfers
 - Irrevocable transfers

Planning Prior to Dissolution -cont.-

- Categories of property – cont.
 - Irrevocable transfers if the decedent retained the right to or enjoyed the possession or use of the income or principal or the property
 - Valuation issues
 - Life insurance policies
 - Annuities

Planning Prior to Dissolution -cont.-

- Categories of property – cont.
 - Pension and retirement plans
 - Transfers and gifts made within one year of death
 - Termination of includable right or interests
 - Transfers to elective share trusts
 - Surviving spouse is entitled for life to the use of the property or all of the income at least annually
 - QTIP trusts – Sec. 2056(b)(7)

Planning Prior to Dissolution -cont.-

- The elective share – cont.
 - Satisfaction of the elective share
 - Planning with the elective share
 - Marital agreements
 - Create an entity
 - Create an elective share trust
 - Make gifts

Planning Prior to Dissolution -cont.-

- Pretermitted Spouse
 - A possible alternate to the elective share
 - UPC Sec. 2-301
 - A person marries after making a will
 - Survived by his or her spouse
 - No pre-marital agreement
 - The will does not provide for or specifically omit the spouse
 - The surviving spouse may be entitled to a portion of the decedent's estate

Planning Prior to Dissolution -cont.-

- Pretermitted spouses – cont.
 - Check specific state statutes carefully
 - Planning options:
 - Enter into a pre-marital agreement and specifically waive the share of a pretermitted spouse
 - Amend his or her documents to specifically provide for the spouse or specifically omit the spouse

Other Planning Considerations

- E After the execution of pre and post-marital agreements, both parties probably need to execute new estate planning documents and beneficiary designation forms to eliminate any potential inconsistencies
- E The documents need to conform to the specific requirements set forth in the marital agreements
- E Also, remember that various forms of property ownership, estate planning documents and beneficiary designations may be revoked automatically by divorce or marriage

Other Planning Considerations – cont.

- E Will and trust provisions
 - Specify that distributions and other provisions are intended to be in satisfaction of the specific requirements of the marital agreement.
 - UPC Secs. 2-202 and 2-204
- E Coordinate any future changes in estate and financial documents with the marital agreement

Other Planning Considerations – cont.

- E Complete all instruments prior to marriage even if a pre-marital agreement is not used
- E In most states, marriage (like divorce) results in a partial or complete revocation of a will
 - Unless there has been a provision made for such a contingency
 - Some states specifically allow this
 - E CN, WA, KANS, MICH

Other Planning Considerations – cont.

- Make instruments contingent upon marriage
 - Prior documents will be in effect if the marriage is delayed or cancelled
 - Specifically refer to any pre-marital agreement
- Coordinate the new will/codicil with the revocable trust agreement
 - You may have to revoke the old trust and do a new one
 - Amendment and restatement of the entire RTA is the better technique

DOMESTIC RELATIONSHIPS

Planning for Dissolution of Domestic Partner Relationships

- Introduction
 - See: Alexander, Robert G. "Estate Planning or Non-traditional Families". 2008
 - Same sex or opposite sex couples
 - Federal law
 - Defense of Marriage Act – "DOMA"
 - A union between one man and one woman

Domestic Relationships – cont.

- **State law** – a growing area of the law!
 - Common law marriages
 - Registered domestic partnerships
 - Same sex marriages
 - Civil unions
 - Reciprocal beneficiaries
 - Contractual rights
 - Quasi-contractual rights
 - Partnership agreements

Domestic Relationships – cont.

- **Legal differences between married couples and domestic partners**
 - No federal estate or gift tax marital deduction
 - No ability to gift split
 - Federal income tax filing
 - Cannot file a joint return
 - Cannot file as married filing separately

Domestic Relationships – cont.

- **Legal differences – cont.**
 - Cannot rollover IRA or tax qualified plan benefits
 - A domestic partner is not a family member for GSTT purposes
 - 37 1/2 years younger is a generation skip
 - No intestate rights
 - No elective share rights
 - No family allowance

Domestic Relationships – cont.

- Legal differences – cont.
 - No exempt property rights
 - No tenancy by the entirety
 - No right to be appointed as a personal representative/executor
 - No ability to disclaim property under Sec. 2518 and continue to retain an interest in such property
 - No rights as to children – visitation, custody, support, etc.
 - Health care privacy issues

Domestic Relationships – cont.

- Planning for dissolution of the relationship
 - Domestic partner agreements
 - Issues as to enforceability
 - Scope of the agreement
 - Tax issues
 - Income tax
 - DOMA prohibits the application of Secs. 71 and 215
 - Gift tax
 - Sec. 2516
 - Estate tax

Domestic Relationships – cont.

- Planning for dissolution of the relationship – cont.
 - Joint tenancies
 - Tenancies by the entirety
 - Partnership agreements
 - Wills
 - Trusts

Domestic Relationships – cont.

- Planning for dissolution of the relationship – cont.
 - Durable powers of attorney
 - Health care powers of attorney
 - Living wills
 - HIPAA forms
 - Irrevocable trusts

Domestic Relationships – cont.

- Other planning issues
 - A domestic partner is not a family member for purposes of either the GSTT provisions or for the valuation rules of Chapter 14
 - FLPs and FLLCs
 - Preferred interests
 - Payment provisions
 - GRITs
 - Etc.
 - Income, estate and gift tax definitions of related persons, adverse interests, independent trustees

Domestic Relationships – cont.

- Other planning issues – cont.
 - Distribution standards
 - Creditor rights
 - Asset protection planning
 - Benefits planning – Title XIX, etc.
 - Life insurance – insurable interest

PLANNING CONSIDERATIONS
WITH RESPECT TO
FAMILY OWNED BUSINESSES

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BREAKING UP THE
FAMILY BUSINESS

■ Advance Planning Considerations

- Pre-marital agreements
- Pre-incorporation or pre-organization agreements
 - A method is set out which will allow the parties to separate and possibly require:
 - Buy-sell agreements
 - Others

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Advanced Planning – cont.

■ Stock sale restrictions

■ Buy-sell agreements

■ Two classes of ownership interests from the inception

- Voting vs. non-voting
- Dividend preferences

■ Voting agreements or voting trusts

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Advanced Planning – cont.

- ☐ Do not create multiple ownership interests
 - Avoid giving up ownership interests by using alternative techniques:
 - ☑ Phantom stock
 - ☑ Stock appreciation rights
 - ☑ Non-voting stock
 - ☑ Restricted stock
 - ☑ Profit sharing bonuses
 - ☑ Advisory board membership
 - ☑ Titles, perks and other entitlements

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Advanced Planning – cont.

- ☐ Operate the company in separate divisions or subsidiaries
- ☐ Examples:
 - Office equipment and design departments
 - Construction equipments sales and rental divisions
 - Commercial and residential construction
 - New and used car sales
 - Operating company and real estate division
 - Companies doing business in separate states or countries
 - Companies with multiple locations
 - Union vs. non-union

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Advanced Planning – cont.

- ☐ Spousal consent to waive interests in qualified retirement plan benefits
 - ERISA Regs. Sec. 1.401(a)20
- ☐ Psychological/family counseling
 - Incorporate a requirement into pre-organization and pre-marital agreements?
- ☐ Mediation, arbitration or collaborative initiatives

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Techniques to Make an Equitable Division of the Business

■ **Introduction**

- Consider the tax ramifications
- Balance the tax costs
 - Compare tax brackets and the utility of the income, deductions and credits
 - Ordinary income vs. capital gains
 - AMT
- Spell out the tax ramifications in the agreement
 - Adjustments in payments based on IRS adjustments

Techniques – cont.

- The following techniques can be used individually or in combination
- The techniques are limited only by the imagination of the professional advisors

Selected List of Business Break-up Techniques

- Spin-off, split-off and split-ups. IRC Sec. 355
 - Each shareholder ends up with a separate corporation
 - Tax-free type D reorganization – Sec. 368(a)(1)(D)
- Buy-sell agreements
 - Watch the valuation rules of Chapter 14

Break-up Techniques – cont.

- Buy-sell planning considerations
 - Cross purchase agreement
 - Business redemption agreement
 - Hybrid agreements
 - Obligations to purchase vs. right of first refusal
 - Valuation and pricing techniques
 - Others

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Break-up Techniques – cont.

- Installment notes – Sec. 453
 - Watch related party sale and disposition rules
- Self-cancelling installment notes
- Sec. 1041 transfers in settlement of marital property rights
 - Stock redemptions – Sec. 302
 - Alimony redemptions – Sec. 71
- Alimony trusts – Sec. 682(a)

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Break-up Techniques – cont.

- Multiple classes of stock
- S corporations, partnerships and LLCs
- Compensation agreements
 - Wage continuation
 - Consulting agreements
 - Covenant not to compete

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Break-up Techniques – cont.

- Life, health, disability, long-term care and other insurance payments
- Retirement plan QDROs
- Charitable gifts of business interests
 - Watch AMT
 - Charitable remainder trusts
 - Charitable stock bailouts

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Break-up Techniques – cont.

- Employee Stock Ownership Plans (ESOPs) – Sec. 4975 and Sec. 1042 (tax-deferred payments)
- Charitable Remainder Employee Stock Ownership Plan (CHESOPs) with family business interests
- Age weighted retirement plans
- Defined benefit and target benefit pensions plans
- Cross-tested profit sharing plans

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Break-up Techniques – cont.

- Sale and lease-backs
- Sale of the business to outsiders
- Take the business public
- Form a new business and have the family business license its know-how to the new company
- Family limited partnership and LLCs
- Voting trusts

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Ethical Issues – Critical!

- Ⓔ Conflicts of interests
- Ⓔ Representation of multiple parties
- Ⓔ Confidentiality
- Ⓔ Written agreements
- Ⓔ Privileged communications
- Ⓔ Tax representation
 - Circular 230
 - New preparer penalties
 - Valuation and disclosure requirements

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Robert G. Alexander, JD, LL.M., AEP, EPLS

Biography

Attorney Robert G. Alexander is the President and majority shareholder of Alexander & Klemmer, S.C., located in Milwaukee, Wisconsin and “Of Counsel” to Gonzalez, Saggio & Harlan, LLP, a highly respected national law firm with offices located in major cities throughout the United States where he serves as the co-chair of their estate and asset protection planning group. He entered private practice in 1978, and concentrates his practice in the areas of domestic and international wealth transfer, asset protection and family business planning, including federal estate and gift taxation, trust and estate administration, fiduciary income taxation, life insurance planning, retirement planning, charitable planning, business organization and succession planning and international tax planning. Attorney Alexander is a graduate of the University of Wisconsin - Madison (B.A. English, 1971), the University of Wisconsin - Madison Law School (J.D., 1976), and DePaul University (LL.M. Taxation, 1984). He is admitted to practice before all courts in the State of Wisconsin, the U.S. Federal Courts for the Eastern and Western Districts of Wisconsin, the Seventh Circuit Court of Appeals and the U.S. Tax Court. He is a member of the American Bar Association sections on Real Property, Probate and Trust Law and Taxation; the State Bar of Wisconsin; the National Association of Estate Planners and Councils; the Milwaukee and Waukesha Estate Planning Councils; and the Society of Financial Service Professionals. He has earned professional designations as a Board Certified Estate Planning Law Specialist (EPLA) as accredited by the American Bar Association and as an Accredited Estate Planner (AEP) by the NAEPC. Attorney Alexander currently holds the office of Secretary for the National Association of Estate Planner & Councils and serves on the board of directors of the Estate Planning Law Specialist Board, Inc. (2003 to the present). He is the chairperson of the NAEPC professional development and education committee, serves on the NAEPC committee administering the accredited estate planner designation, and the NAEPC Foundation Committee. He is an NAEPC delegate to the Synergy Summit, a leading national estate, tax and financial think tank, where he also serves as the immediate past chairperson and is on the editorial advising board of Wealth Management Magazine. He served for two years as the original Publishing Editor of the NAEPC’s academic journal, *The NAEPC Journal of Estate and Tax Planning*; and for three years on the board of directors of the Milwaukee Estate Planning Council. Attorney Alexander is a nationally known author and speaker who lectures and teaches extensively for both public and private organizations including the NAEPC, continuing legal education providers, the Wisconsin Institute of CPA’s, major insurance companies, brokerage firms, banks, trust companies, community foundations, charitable organizations and various local colleges.