Copyright 2000

TRANSFERS OF COMMUNITY PROPERTY IN QUALIFIED PLANS AND IRAs
(Not in a Nutshell)
A Guide for the Justly Confused

The seven numbered paragraphs below condense the basic rules regarding transfers of a community property interest in a qualified plan or IRA, primarily at death. Following the summary is a more detailed description of how the rules were derived.

1. Under Texas law (disregarding ERISA[1]), an interest in a qualified plan or IRA, to the extent acquired during marriage, is most likely community property of the marriage. Since, in Texas, the interest on separate property is community property, a portion of a retirement plan or IRA may be community property even if originally acquired prior to marriage.

2. Under Texas law (disregarding ERISA), community property can be awarded to either spouse on divorce. Under Texas constitutional law, a divorce court cannot divest a spouse of the spouse's separate property.

3. Under Texas law (disregarding ERISA), a participant in a qualified plan or an IRA owner may dispose of both halves of the community property interest in a plan or IRA at death, absent "fraud on the surviving spouse."[2] This is accomplished by beneficiary designation, and not by a will. (It is remotely possible that a court would hold that a beneficiary designation purporting to dispose of both community halves of an IRA is an "illusory trust," under the rationale of *Land v. Marshall*.[3])

4. Under Texas law (disregarding ERISA), a nonparticipant spouse (the husband or wife of a participant in a qualified plan or an IRA owner) **may dispose of the nonparticipant spouse's community one-half interest in the surviving spouse's plan or IRA at death**, if the nonparticipant spouse predeceases the spouse that is the plan participant or IRA owner. This is accomplished by will or intestate succession, and not by beneficiary designation.

5. Under Federal law, community property that is subject to ERISA is divisible on divorce only in accordance with certain rules and procedures set forth in ERISA

[1]The Employee Retirement Income Security Act of 1974, 29 U.S.C. §1001, et seq., as amended.

[2]Under Texas law (disregarding ERISA), and absent fraud on the spouse, an individual can make a gift, during lifetime, of both halves of community property that is under that individual's sole management and control (e.g. earnings from employment, or the proceeds of earnings). Under Texas law an individual **cannot** dispose of both halves of the community by testamentary disposition (i.e., by will), and this is true even with respect to sole management community property. Under Texas law (disregarding ERISA), and absent fraud on the spouse, an individual can effect a transfer of both halves of sole management community property at death, if it is done by contract or similar nontestamentary arrangement (i.e., not by will), for example, pursuant to a life insurance contract on the life of the individual, or pursuant to a beneficiary designation under a qualified plan or IRA.

[3]*Land v. Marshall,* 426 S.W.2d 841 (Tex. 1968). In that case, any attempt by an IRA owner to dispose of a nonparticipant spouse's community property interest in an IRA at death would be set aside, even in the absence of "fraud on the spouse." However, it is worth noting that to date no court has extended the illusory trust doctrine to IRAs. Indeed, *Land v. Marshall* has been cited in only one case since the decision was rendered, and in that case, the doctrine was held not to apply. *Westerfeld v. Huckaby*, 462 S.W.2d 324 (Tex. Civ. App.— Houston [1st Dist.] 1971, affm'd, 474 S.W.2d 189 (Tex. 1972)).

§206(d)(3) and IRC[4] **§414(p).**[5] **In addition, the interest may be disposed of at death only in accordance with ERISA §205 and IRC §§401(a)(11) and 417.**[6] ERISA and the IRC will require the plan to contain language embodying these restrictions, but ERISA, if it applies, will apply regardless of the plan language. (Curiously, a qualified plan might be subject to Subchapter D of the IRC, and yet not be subject to ERISA,[7] in which case, state law would not be preempted, which could render the plan language meaningless, affecting the plan's qualification we know not how.)

6. Most, but not all, **qualified plans**[8] **are subject to ERISA**.[9]

7. ERISA ordinarily will not apply to an IRA,[10] **even a rollover IRA**, though some lawyers are speculating that since the Supreme Court has not addressed the rollover issue specifically, this issue may be open. Incidentally, a SEP (Simplified Employer Plan) is a form of IRA. It is not a qualified plan because it is not described in IRC §401(a). Hence, it too is usually exempt from ERISA, like any other IRA.[11]

The path leading to the conclusions set forth above is a tortured one that took a long time to blaze; moreover, we may not be at the end of the road, and some of the conclusions may need qualification. Hence, a more detailed discussion follows.

* * * *

[4]All references herein to the "IRC" are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[5]These are the rules governing qualified domestic relations orders (QDROs).

[6]For example, the participant's power to dispose of his or her interest in a plan subject to IRC §401 or to ERISA is severely limited by the joint and survivor annuity and rules of §§401(a)(11) and 417.

[7]For example, a qualified plan that has no common law employees, or which employs only the sole owner and (or) the owner's spouse is not subject to ERISA, according to DOL Reg. §2510.3-3(c)(1), *Meredith v. Time Insurance Company,* 980 F.2d 352 (5th Cir., 1993), 16 EBC 1296, *In Re Lane, Jr.* (1993, ED NY) 1993 Bankr LEXIS 103, *In Re Branch, Robert L.* (1994, CA7) 1994 US App LEXIS 2870, *Robertson v. Alexander Grant & Co.*, 798 F.2d 868 (5th Cir. 1986), cert. den. 479 U.S. 1089, 107 S.Ct. 1296 (1987), *In re Kaplan,* 162 B.R. 684 (Bkrtcy. E.D. Pa. 1993), *In Re Blais,* (1994, BC SD FL) 1994 Bankr Lexis 1427, and *Fugarino v. Hartford Life and Accident Insurance Company,* 969 F.2d 178 (6th Cir. 1992).

[8]"Qualified" means qualified under IRC §401(a).

[9]ERISA §3(2)(A).

[10]DOL Reg. §2510.3-2(d).

[11]Compare *Taft, Robert In re,* (1995, DC NY) 184 BR 189 and *Henderson In re*, (1993, Bktcy Ct MS) 167 BR 67 [SEPs not ERISA plans], with *Schlein In re*, (1993, CA11) 8 F3d 745, 17 EBC 2020 and *Garratt v. Walker* 121 F.3d 565 (10th Cir., 1997), 21 EBC 1444, 1997 US App Lexis 19291 [SEP is governed by ERISA].

Pension Plan Benefits Are Community Property If Earned in Texas While Married. It is axiomatic in Texas that compensation earned while married is community property and that the interest on separate property is community property. Pension benefits are a form of deferred compensation. Thus, the courts, not just in Texas but in most if not all community property states, have long held that benefits under a deferred compensation plan or rollover IRA, whether or not qualified and whether or not vested, are a form of community property, if acquired during the marriage.[12] Further, the Texas Supreme Court has held that, as a matter of state law, community property retirement plan benefits **(1)** are divisible in favor of the nonparticipant spouse in the case of divorce,[13] and **(2)** on the death of the nonparticipant spouse, those benefits are subject to testamentary or intestate disposition. This means that on death the nonparticipant spouse's interest in the participant's qualified plan or IRA —unless preempted by federal law— will pass under the spouse's will[14] (if the spouse has a will), either as a specific gift if mentioned specifically, or as a part of the residuary estate if not mentioned at all. If there is no will, the interest will pass under the laws of intestate succession.[15] In light of these Texas Supreme Court cases, it is safe to say that the state law characterization issue is fairly well settled.

Having determined that an interest in a qualified plan may be community property, we might wish to address here the questions of (a) what value to assign the interest and (b) how to apportion, between the community and separate property estates, interests acquired in part while unmarried and in part while married. In the case of an IRA or individual account plan, the value of the nonparticipant's community property interest at any point in time will be roughly half the value of the then existing account balance if fully vested and if the spouses have been married since the inception of the plan. However, valuing an interest in a defined benefit plan under any circumstances, valuing the benefits of a defined contribution plan where the parties have not been married throughout the period benefits accrued, and valuing interests subject to forfeiture, are matters far too recondite for consideration here, and accounts, in part, for the fact that pension and divorce lawyers charge such high fees. It will have to suffice to say that the law is somewhat unsettled (read, just short of unintelligible), despite the best of efforts,[16] and on this subject reasonable (and occasionally unreasonable) minds can and do differ.

* * * *

---

[12]*Herring v. Blakeley,* 385 S.W.2d 843 (Tex. 1965); *Cearley v. Cearley,* 544 S.W.2d. 661 (Tex. 1976); *Taggart v. Taggart,* 552 S.W.2d 551 (Tex. 1977); *Allard v. Frech,* 754 S.W.2d (Tex. 1988).

[13]*Berry v. Berry,* 647 S.W.2d 945 (Tex. 1983); *Grier v. Grier,* 731 S.W.2d 931 (Tex. 1987).

[14]*Allard v. Frech,* 754 S.W.2d 111 (Tex. 1988).

[15]In Texas, **if a nonparticipant decedent dies without a will**, the surviving spouse (the participant) will inherit the nonparticipant's community property, including any community property interest in the participant's plan (or IRA), if the decedent either had no children or all of the decedent's children are the children of the surviving spouse (the participant). However, **if at least one surviving child of the nonparticipant is not the child of the surviving spouse (the participant), then** the decedent's surviving spouse (the participant) retains one-half of the community property and, absent ERISA preemption, **the children** (actually, the descendants *per stirpes*) **collectively divide the decedent 's remaining one-half of the community**.

[16]*Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983); *Grier v. Grier,* 731 S.W.2d 931 (Tex. 1987).

Copyright 2000

The Distinction Between Probate and Nonprobate Assets Can be a Source of Confusion For the Unitiated

A probate asset is property that passes by will or intestacy at the death of the legal owner. a nonprobate asset is one that passes by contract or by beneficiary designation. Life insurance proceeds and qualified plan or IRA benefits are two common types of nonprobate assets. The participant's interest in a qualified plan or IRA passes by beneficiary designation; whereas, the nonparticipant spouse's community property interest in the participants plan or IRA (if any) usually passes, if at all, under the will or the laws of intestate distribution, upon the death of the nonparticipant spouse.

The Participant's Interest in a Qualified Plan or IRA is a "Nonprobate Asset." The interest that a participant has in a qualified plan or IRA that can be transferred at death is commonly referred to and denominated by lawyers as a "nonprobate asset." This term is used because the interest passes by beneficiary designation rather than by will, in much the same manner as the proceeds of a life insurance contract pass on the death of the insured. True, the assets can become a *de facto* probate asset if the decedent's estate is named as the beneficiary, but, absent that special situation, an attempt by the participant or IRA owner to dispose of death benefits under a will would be as ineffectual as an attempt by the insured to do the same with insurance proceeds where someone else was the named beneficiary.[17]

The Nonparticipant Spouse's Interest in an IRA is a "Probate Asset." Ironically, the community property interest of the nonparticipant in the surviving spouse's plan or IRA is a "probate asset" —meaning that it passes by will or intestacy, in the absence of ERISA preemption. This is true, by the way, even with life insurance, where the insured is not the decedent; though in that case, the value of the interest passing under the uninsured spouse's will is limited by the cash value (or, perhaps, by the value of the unearned premium in the case of a term policy).

If not altogether mind boggling, it may at least strike some as anomalous that benefits payable on account of the participant's death are nonprobate assets that can pass only by beneficiary designation or under the terms of the plan —but in any event pass outside of probate and outside of the will—, whereas the interest of the nonparticipant is a probate asset passing under a will or the laws of intestate succession.

Occasionally, one will find an IRA contract that gives the nonparticipant spouse death beneficiary designation rights. Perhaps this makes the nonparticipant a party to the contract and is both permissible and is desirable, assuming that the IRC allows someone other than the IRA owner to be a party to the IRA and that under state law the interest would be converted to a nonprobate asset. My opinion is that neither the IRS nor state law is an impediment in this context, but my opinion is not without at least some reservation.

* * * *

[17] *MacLean v. Ford Motor Co.*, 831 F.2d 723 (7th Cir. 1987).

Copyright 2000

Death Benefits Payable On Account of the Participant's Death Will Be Subject to Special Spousal Benefit Rules, if the Plan is Subject to ERISA. Strictly speaking, death benefits payable on account of a participant's death will be governed by the terms of the plan, whether or not the plan is subject to ERISA, as a matter of contract law; but if the plan is a qualified plan, it will contain the spousal benefit rules of REA.[18] **REA requires a qualified plan, depending on its nature and terms, to either require (1) that the nonparticipant surviving spouse be the beneficiary of the participant's entire remaining undistributed interest if the participant dies before the interest is entirely distributed; or (2) that the spouse be guaranteed the right to an annuity for life.** The spouse may waive this right if certain detailed procedures are followed. Absent a qualified waiver, the annuity must either be in the form of a Qualified Preretirement Survivor Annuity (**QPSA**), or in the form of a Qualified Joint and Survivor Annuity (**QJSA**), depending on whether the participant dies before retirement.[19]

In a defined benefit plan, the QJSA is an annuity for the life of the participant with a survivor annuity for the life of the spouse which is not less than 50% (and is not greater than 100%) of the amount of the annuity that is payable during the joint lives of the participant and the spouse, and that is the actuarial equivalent of a single annuity for the life of the participant.[20] The QJSA in a defined contribution plan subject to REA is defined similarly to that of a QJSA in a defined benefit plan, although the annuity to be provided will be whatever can be purchased with the participant's nonforfeitable account balance.

In a defined benefit plan, the QPSA is defined as an annuity payable to the surviving spouse in an amount that is not less than the amounts that would be payable as a survivor annuity under the QJSA.[21] In the case of a defined contribution plan, the IRC contains a special rule that defines the QPSA as an annuity for the life of the surviving spouse having a value of no less than one-half the participant's nonforfeitable account balance under the plan, determined at date of death.[22]

---

[18]The Retirement Equity Act of 1984 (P.L. 98-397, Aug. 23, 1984).

[19]"Retirement" here is a term of art, the full explication of which will not be undertaken at this juncture. It means different things in different contexts. Here, I use the term "retirement" to mean the first day of the first period for which the Plan makes a distribution.

[20]IRC §417(b).

[21]IRC §417(c)(1)(A).

[22]IRC §417(c)(2).

Copyright 2000

The survivor annuity rules apply to all qualified plans *except* for certain profit sharing plans and their close kindred (stock bonus plans, 401(k) plans, ESOPs, etc.) that are not subject to the minimum funding requirements of IRC §412.[23] In order for a profit-sharing type plan to be exempt, the plan must provide that in the absence of a qualified waiver, the participant's entire undistributed nonforfeitable account balance under the plan must be payable in full to the participant's surviving spouse on the death of the participant.[24] **Note, however, that under the profit sharing type plan exception, there are no restrictions on benefits paid out during the participant's life!**

These rules apply without regard to whether the benefit involved is community property. In a defined contribution plan subject to the joint and survivor annuity rules, the QPSA need only be half the participant's account balance, and unless the plan provides otherwise, the other half can be left to someone other than the spouse. Assuming that we can agree that the half that goes to the spouse represents the spouse's community property interest, this works out rather nicely. What will a court do, however, if the spouse gratefully accepts the benefits guaranteed by ERISA, and then claims half of the half remaining? This sort of overreaching has been tried, but failed.[25] Properly argued, the survivor would have to assert the "fraud on spouse" doctrine, and it is doubtful that a court would be sympathetic. A good beneficiary designation would provide that "the interest passing to my spouse under this designation shall be satisfied first out of my spouse's community one half interest (if any) in my death benefits."

* * * *

If the Plan is Not Subject to ERISA, the Participant Can Generally Provide That His Or Her Death Benefits Under The Plan (Or IRA) Will Pass To Anyone, Within Limits, Unless *Land v. Marshall*[26] is Extended to Apply Here. Under Texas law, a spouse can give away **during life** both halves of the community property subject to the spouse's sole management and control. However, a spouse does not have the power to dispose of the survivor's half of the community by will, without consent. A nonprobate disposition is treated in the same manner as a lifetime gift, perhaps because it is not made by will, or perhaps because the gift is considered made during life, subject to revocation at death. In any event, it is well established in Texas that a spouse can make a nonprobate disposition of both halves of the spouse's sole management community property by naming someone other than the spouse as the beneficiary, within limits. Common examples include a gift of death benefits under a life insurance contract or a qualified plan or IRA.

---

[23] IRC §401(a)(11)(ii).

[24] The benefit need not be payable as an annuity, however. The specific requirements for exemption from the survivor annuity rules are set forth in IRC §401(a)(11)(B).

[25] See *Employee Savings Plan of Mobil Oil Corp. v. Geer,* 535 F. Supp. 1052, 1055 (S.D. NY 1982).

[26] *Land v. Marshall,* 426 S.W.2d 841 (Tex. 1968).

Copyright 2000

Property subject to a spouse's sole management and control includes property that would have been the spouse's separate property if the spouse were not married, and specifically includes earnings and wages. Accordingly, **a participant's community interest in a qualified plan or rollover IRA, having been acquired in connection with employment and as compensation, will almost always be sole management community property**.

The Fraud on the Spouse Doctrine. The ability to give away during life or by nonprobate disposition both halves of community property subject to the donor's sole management and control is limited by the doctrine of "fraud on the spouse." If, by reason of the size of the gift in relation to the total size of the community estate, the adequacy of the estate to support the other spouse, and the relationship of the donor to the donee, the gift constitutes constructive fraud, the burden will be on the donor to prove that the gifts of his share of the community property are fair, otherwise the gift will be set aside.[27] In most cases, but not always, if the donee is a related party, the disposition will be allowed to stand. If the donee is an unrelated party, the gift will usually be set aside.

> "The 'fraud on the community' or 'fraud on the spouse' doctrine is a judicially created concept based on the theory of constructive fraud. *Givens v. Girard Life Insurance Company of America,* 480 S.W.2d 421, 425 (Tex. Civ. App.--Dallas 1972, writ ref'd n.r.e.). Constructive fraud is the breach of a legal or equitable duty which violates a fiduciary relationship, as exists between spouses. A presumption of constructive fraud arises where one spouse disposes of the other spouse's one-half interest in community property without the other's knowledge or consent. See *Redfearn v. Ford,* 579 S.W.2d 295, 296-97 (Tex. Civ. App.--Dallas 1979, writ ref'd n.r.e.). The burden of proof is then on the disposing spouse or his donee to prove the fairness of the disposition of the other spouse's one-half community ownership. *Estate of Korzekwa v. Prudential Insurance Company of America,* 669 S.W.2d 775, 777 (Tex. App.--San Antonio 1984, writ dism'd); *Redfearn,* 579 S.W.2d at 297; *Givens,* 480 S.W.2d at 425. Where the donee or beneficiary is related to the disposing spouse or decedent, the courts look to three factors in determining the fairness of the disposition: (1) the relationship of the beneficiary to the decedent; (2) whether special circumstances tend to justify the gift; and (3) whether the community funds used were reasonable in proportion to the remaining community assets. *Givens,* 480 S.W.2d 421, 426, cited with approval in *Great American Reserve Insurance Co. v. Sanders,* 525 S.W.2d 956, 958-59 (Tex. 1975); *Redfearn,* 579 S.W.2d at 297. We hold that the disposing spouse or his donee has the burden to prove these three factors in order to rebut the presumption of constructive fraud."[28]

---

[27] *Marshall v. Marshall,* 735 S.W.2d 587 (Tex. App.-Dallas 1987, no writ history to date); *Horlock v. Horlock,* 533 S.W.2d 52, 55 (Tex. Civ. App.-Houston [14th Dist.] 1975 writ ref'd n.r.e.); *Carnes v. Meador,* 533 S.W.2d 365 (Tex. Civ. App.-Dallas 1975, writ ref'd n.r.e.); and *Tabassi v. NBC Bank-San Antonio,* 737 S.W.2d 612 (Tex. App.-Austin 1987 no writ history to date). See also 29 Baylor Law Review 608.

[28] *Jackson v. Smith,* 703 S.W.2d 791 (Tex. Civ. App.-Dallas 1985, no writ) pp. 795-796.

Copyright 2000

Even if the nonprobate disposition would be in fraud on the spouse, if the spouse is left anything at all under the will, the spouse could be put to an election so that benefits under the will would be eliminated if the fraud on spouse doctrine were to be asserted.

The Illusory Trust Doctrine—*Land v. Marshall*.. In 1968 the Texas Supreme Court decided a case[29]that enunciated a principal which, if extended, could wreak havoc in all sorts of areas. Fortunately, the case has largely been ignored outside of situations fitting the exact same facts, and in 30 years has only been cited once in this State. In *Land v. Marshall,* 426 S.W.2d 841 (Tex. 1968), the husband established a revocable grantor trust during life. At death, the entire community estate was to continue to be held in trust for the benefit of the wife. Because the wife was a beneficiary of the trust following the husband's death, the doctrine of "fraud on the spouse" did not apply. The Court, nevertheless, held that the trust was illusory.

> The central question in this case arises out of an apparent conflict in the law and policy of our community property system. **The husband, under Texas law, has managerial powers over the wife's community interest. However, the husband's managerial powers do not extend beyond his death so as to allow the husband to dispose of the wife's community interest by his will.** The wife, for that reason, has the right to elect to take under or against her husband's will when he undertakes to dispose of her community share upon his death. Thus, the question is whether the husband can accomplish by inter vivos trust what he could not do by a will. The wife contends that her husband could not control the disposition of her community share by the trust instrument.
>
> Conversely, the proponents of the trust point out many situations in which it is sound management by the husband to create an inter vivos trust of the wife's community interest even though its disposition is effected upon his death. We believe the paradox can be resolved by the doctrine of illusory trusts. **Under the doctrine, the husband has the power to create an inter vivos trust as a part of his managerial powers over the wife's share; but when her community share is involved, the wife can require the trust to be real rather than illusory, genuine rather than colorable.**[30]

Because the entire interest was left in trust for the wife, the Court set the entire trust aside, since, in the context, to set only half aside would have defeated the apparent intent of the grantor.

No one and no case, so far as I know, has ever suggested that the *Land v. Marshall* illusory trust doctrine applies to IRAs, though on the surface it would appear that it could, and the decision has been cited in only one case in the 30 years since it was decided.[31] There are perhaps reasons for this.

---

[29]*Land v. Marshall,* 426 S.W.2d 841 (Tex. 1968).

[30]*Land v. Marshall,* 426 S.W.2d 841 (Tex. 1968).

[31]*Westerfeld v. Huckaby*, 462 S.W.2d 324 (Tex. Civ. App.— Houston [1st Dist.] 1971, affm'd, 474 S.W.2d 189 (Tex. 1972)).

Copyright 2000

Land v. Marshall has been frequently criticized by the commentators, and there are several factors that militate against its extension to IRAs or other forms of nonprobate dispositions. First, the case was decided prior to the advent of the Family Code, at a time when the husband had sole control and management over the entire community, no matter the source of the funds. The Family Code has changed this rule, so that a husband can no longer divest a wife, by use of a revocable trust, of property acquired by the wife's earnings. To the extent that *Land v. Marshall* was decided on public policy grounds, that foundation is no longer as sure as it was at the time.

Two other legislative changes that have occurred since Land *v. Marshall* might arguably change the outcome of that case were it decided today, or at least would be persuasive that the doctrine not be extended. The Texas Trust Code now contains language that explicitly sanctions self-settled grantor controlled revocable trusts in Texas.[32] Further, the enactment of Chapter XI of the Probate Code "Nontestamentary Transfers," also weakens the public policy arguments otherwise supportive of the case —the legislature having the primary jurisdiction to determine what is or is not the public policy.

Sec. 450. Provisions for Payment or Transfer at Death.

(a) Any of the following provisions in an insurance policy, contract of employment, bond, mortgage, promissory note, **deposit agreement**, employees' trust, **retirement account**, deferred compensation arrangement, custodial agreement, pension plan, trust agreement, conveyance of real or personal property, securities, accounts with financial institutions as defined in Part 1 of this chapter, or any other written instrument **effective as a contract,** gift, conveyance, **or trust** is **deemed to be nontestamentary**, **and this code does not invalidate the instrument** or any provision:

(1) that money or other benefits theretofore due to, controlled, or **owned by a decedent shall be paid after his death to a person designated by the decedent**[33] in either the instrument or a separate writing, including a will, executed at the same time as the instrument or subsequently;

(2) that any money due or to become due under the instrument shall cease to be payable in event of the death of the promisee or the promisor before payment or demand; or

[32] Tex. Trust Code §112.033.

[33] Query whether or not §450 could be construed to apply to the nonparticipant (NPS) where the NPS is not a party to the contract. §450(a)(1) states that "benefits . . . due to a . . . decedent . . . shall be paid after his death to a person designated by the decedent in a . . . will . . . " A common sense reading would be that the decedent referred to is the decedent who is the party to the contract. On the other hand, "decedent" is not defined, and it is technically true that the NPS is a decedent and that there are benefits under the contract or account that are "due to" (in some sense) "the decedent" under state law if the benefits are community property.

Copyright 2000

(3) that any property which is the subject of the instrument shall pass to a person designated by the decedent in either the instrument or a separate writing, including a will, executed at the same time as the instrument or subsequently.

(b) Nothing in this section limits the rights of creditors under other laws of this state.

(c) In this section:

* * * *

(2) "Individual retirement account" means a trust, custodial arrangement, or annuity under Section 408(a) or (b), Internal Revenue Code of 1954 (26 U.S.C.A. Sec. 408 (1986)).

(3) "Retirement account" means a retirement-annuity contract, **an individual retirement account,** a simplified employee pension, or any other retirement savings arrangement.

* * * *

Added by Acts 1979, 66th Leg., p. 1756, ch. 713, Sec. 31, eff. Aug. 27, 1979. Subsec. (a) amended by Acts 1987, 70th Leg., ch. 94, Sec. 1, eff. Aug. 31, 1987; Subsec. (c) added by Acts 1987, 70th Leg., ch. 94, Sec. 2, eff. Aug. 31, 1987. Subsection (a) amended by SB 506, enacted June 20, 1997, effective September 1, 1997.

Land v. Marshal does not impose a facts and circumstances test. Therefore, unless §450 overrules *Land v. Marshal* in the case of a trusteed IRA, then the statute would be virtually meaningless in the case of a married participant. And this hardly seems likely. On the other hand, I would not go so far as to say that the statute eliminates the fraud on the spouse doctrine, since that is a subjective test. A defrauded spouse would be a creditor or sorts and “nothing . . . [under the statute] limits the rights of creditors under other laws of this state.” I take a moderate position on this issue, and would argue that by declaring that an IRA is a nonprobate asset §450 overrides the illusory trust doctrine if it would otherwise be applicable, but leaves the fraud on the spouse doctrine intact. We shall see.

At the very least, I would expect that the payor (IRA-trustee) can rely on 450 as giving the married participant the *prima facie* power to designate a death beneficiary with respect to both halves of the community. If the spouse has any rights in proceeds that are payable to another distributee, these rights would have to be established in an action against the distributee rather than against the payor.

Finally, it is worth noting that in reaching its opinion the Court prominently cited *Newman v. Dore,* 275 N.Y. 371, 9 N.E.2d 966, 112 A.L.R. 643 (1937), a case that had been repealed by statute in New York where the case was decided, a point overlooked by the Texas Court.

Copyright 2000

* * * *

If The Plan Or IRA Is Not Subject To ERISA, The Nonparticipant Spouse Can Freely Dispose Of One-Half Of The Community Property Interest Under The Plan Or IRA.[34] The Texas Supreme Court in the seminal decision of *Allard v. Frech* has made it clear that under state law the nonparticipant can transfer by will or intestate succession his or her community property interest in the participant spouse's retirement plan. If the transfer is back to the participant, life is simplified. If, however, the interest is transferred to persons other than the participant, there are some pesky tax problems to consider.

Who is Taxed on What When the Nonparticipant's Interest is Distributed to Someone Other than the Participant During the Participant's Lifetime? Obviously, if the beneficiary of the nonparticipant's interest is not the participant, the situation is awkward at best. A few of the more obvious questions are: (1) When must the interest be paid out? (2) When the interest is paid out, who owes the income tax on it? (3) When the interest is paid out, who pays the premature distribution excise tax on it, if any is due? There are no clear answers to these questions, and in any event I won't fully explore them here; but I will, nevertheless, hazard an opinion.

(1) I don't think there is any time limit *per se* on when the nonparticipant's interest must be paid out. It would have to be paid out immediately if demand were made, but in the absence of a demand by the nonparticipant's beneficiaries or executor, it ought to be paid out when the parties agree. The IRC §401(a)(9) minimum required distribution (MRD) rules will require that distributions be made sooner or later, but I believe that the fact that the nonparticipant's estate has an interest will be largely (though perhaps not completely) irrelevant in determining the time and amounts of the MRDs.

(2) There is almost no law on the question of who is taxed on the income when a distribution is made from a living participant's IRA to the estate or beneficiaries of predeceased spouse, whose interest was acquired as a result of the community property laws. Presumably, if IRC §408(g) were literally applied, the participant would have to foot the income tax bill, although an equitable right of recovery might also obtain. However, the Service has held in a private letter ruling that beneficiaries owe the income tax on amounts distributed to them during the life of the participant/IRA owner, and that the statement found in IRC §408(g) that the IRA rules "shall be applied without regard to any community property laws," relates solely to the deduction rules found in IRC §219.[35] Like *Alice in Wonderland,* sometimes words mean what the IRS says they mean.

---

[34]*Allard v.* Frech, 754 S.W.2d 111 (Tex. 1988).

[35]PLR 8040101. See also, *Rodney Powell, et. al. v. Commissioner,* 101 T.C. 32 (1993).

Copyright 2000

(3) The exception to the 10% premature distribution tax under §72(t)(2)(A)(i), for distributions (prior to age 591/2) made on account of death, does not apply here because the death referred to is that of the employee. However, the tax does not apply unless the distribution is includible in gross income.[36] Further, the tax is on amounts received by the taxpayer. Therefore, if the tax applies at all, it is arguable that it is owed by the beneficiary of the nonparticipant spouse's interest.

* * * *

If the Plan is Subject to ERISA, the Nonparticipant Spouse May Be Unable to Transfer His or Her Community Property Interest in the Participant's Plan. If the issue were solely one of Texas law, the spouse (the nonparticipant spouse) of an IRA owner or qualified plan participant would be able to dispose of that interest on the death of the nonparticipant spouse. However, **if the qualified plan is subject to ERISA, federal law will preempt the spouse's power of testamentary disposition.**

The problem is not with state law but with federal law, which is to say that the problem is with ERISA §514(a), which provides:

> Except as provided in subsection (b) of this section, the provisions of this title and title IV shall supersede any and all State laws insofar as they may now or hereafter **relate to** any employee benefit plan described in section 4(a) and not exempt under section 4(b).

ERISA §206(d)(1) is also a problem—

> Each pension plan shall provide that benefits provided under the plan may not be assigned or alienated. [Emphasis added.]

Having lost the Civil War, we are not in much of a position to question the authority of Congress in matters governing interstate commerce to enact such a law. But we can and do argue frequently about what the statute means, the term "relate to" being the most common bone of contention. Intellectuals will argue that everything relates to everything else, but as a metaphysical interpretation of the term deprives it of any meaning,[37] the Supreme Court has been more or less forced to make up the rules as it goes along, with the result that the question of whether or not ERISA preemption will apply in a given instance is often a matter of pure guess work, if not happenstance. (As the poet says "[I]t's got no signs or dividing lines and very few rules to guide."[38])

---

[36]IRC §72(t)(1).

[37]Like Kant, the Court is perhaps justly skeptical of metaphysical reasoning.

[38]Robert Hunter, *A Box of Rain*.

Copyright 2000

Despite the prolixity of the preemption cases, in which underlying principals are sanctimoniously, vigorously, and (in my opinion) often absurdly asserted as justifying the result, the plain truth is there are no rules so clear as to cause the outcomes of many of the preemption cases to be predictable. This is amply illustrated by the inordinate number of five to four Supreme Court decisions involving ERISA preemption. One case, in particular —another five to four decision— is directly concerned with the issue at hand, and it is to this case that we will now turn our attention: *Sandra Jean Dale Boggs v. Thomas F. Boggs, et al.*[39] But first some background.

The Rules Governing the Division of The Community Property Interest of a Nonparticipant Spouse On Divorce Are Now Provided By ERISA and the IRC. Until 1986, there was controversy in most all of the community property states[40] regarding the division on divorce of pension benefits subject to ERISA. §204(b) of the 1984 Retirement Equity Act, P. L. 98-397 amended ERISA (by adding §206(d)(3)) and the Internal Revenue Code (by adding IRC §414(p)) to provide that pension benefits could be awarded in a domestic relations action, if otherwise awardable under state law, despite the federal preemption provision of ERISA §514(a), if certain procedures —spelled out clearly(?) in two and a half pages of fine print— are followed. Thus was born the QDRO, the qualified domestic relations order. State and federal courts will continue to stay busy for the foreseeable future, interpreting §414(p) and wrestling with the proper methodology for valuing pension benefits, but we are not going to concern ourselves overmuch with these issues here. Dividing pension benefits in divorce is now more of a question of applying the law than it is of figuring out what it is.

At the beginning of 1997, the last major unanswered question of law remaining in this area was whether state probate laws affecting a participant's interest in a plan were preempted, assuming the plan was subject to ERISA. In this area there is no federal law similar to the QDRO procedures. Prior to the Supreme Court decision in *Boggs*, all we had to go by was the preemption section of ERISA, as variously interpreted by conflicting circuit courts.

The *Boggs* Case. In the late spring of 1997, the United States Supreme Court, in *Boggs v. Boggs,*[41] gave us some needed answers. Whether the answers given raise more questions than they solved remains to be seen. Before discussing the *Boggs* decision in any length, a few brief remarks regarding the history leading up to the decision are in order. These remarks will be kept very brief, because now that the Supreme Court has spoken, most of what went on in the past leading up to the decision is of academic interest only. However, a quick review of some of the cases preceding *Boggs* should be enlightening.

***Employee Savings Plan of Mobil Oil Corp. v. Geer*.** One of the earliest cases recognizing that the nonparticipant spouse had a community property interest in the participant's plan at death was a 1982 New York Federal District Court case, *Employee Savings Plan of Mobil Oil Corp. v.*

---

[39]*Boggs v. Boggs,* 117 S.Ct. 1754, 138 L.Ed.2d 45, 65 U.S. L.W. 4418 (1997).

[40]Texas, California, New Mexico, Arizona, Louisiana, Washington, Idaho, Nevada, and to a limited extent Oklahoma.

[41]*Boggs v. Boggs,* 117 S.Ct. 1754, 138 L.Ed.2d 45, 65 U.S. L.W. 4418 (1997).

Copyright 2000

Geer.[42] The case is interesting for a number of reasons, chief among which is the spouse's legal theory as to why she was entitled to three-quarters of the community benefit rather than half. The decedent —in this case the participant— left half of his pension plan benefits to his wife, and the other half to the children. The wife (who can fairly be described as grasping) maintained that she was entitled **(a)** first of all to her one-half community property interest, and **(b)** secondly, to the one-half that would then pass by the husband's beneficiary designation —"thank you so much"! Of course, under Texas community property law, since the husband died first, his interest would be a nonprobate asset, and in the absence of fraud, he had the power to dispose of the wife's half. Further, even if he did not have this power, it would certainly be overreaching to leave the wife three-fourths of the benefit. The case did not dispose of the spurious state law claims, but did hold, in denying a motion for summary judgment, that ERISA did not preempt the matter. ERISA preemption in this context could still be an issue in the future, because here the participant predeceased the nonparticipant spouse, rather than the other way around as in *Boggs*.

MacLean v. Ford Motor Co. As to the issue of whether or not ERISA preempts the participant's state law rights to dispose of an employee pension benefit, we have the case of *MacLean v. Ford Motor Co.*[43] This case involved the testamentary rights of a participant in a plan to direct, by will, where his death benefits were to go. The court took for granted that state law conferred upon the decedent the power to do this, but found that Federal preemption prevented state law from controlling. Accordingly, the decedent's death benefits under the Ford Motor Company plan passed in accordance with the terms of the plan, rather than in accordance with the state testamentary transfer act.

***Allard v. Frech*.** The first case in Texas to deal with the nonparticipant's interest in a private retirement plan, where the nonparticipant spouse predeceased the participant, was *Allard v. Frech*.[44] This case, which arose in Fort Worth, held that half of the husband's General Dynamics pension passed under the wife's will to a trust for the benefit of the couple's adult children. ERISA preemption was not placed in issue before the court, and so after this case, though we now had a pretty good idea what the state law on the subject was, we really didn't have any idea whether ERISA would have preempted the award of benefits to the children, since it was not argued.

[42]*Employee Savings Plan of Mobil Oil Corp. v. Geer,* 535 F. Supp. 1052, 1055 (S.D. NY 1982).

[43]*MacLean v. Ford Motor Co.*, 831 F.2d 723 (7th Cir. 1987).

[44]*Allard v.* Frech, 754 S.W.2d 111 (Tex. 1988).

Copyright 2000

***Ablamis v. Roper*.** The next significant case to wrestle prominently with the issue arose in the Ninth Circuit, *Ablamis v. Roper*.[45] The 9th Circuit has squarely held that in a fact pattern virtually identical to *Allard* the California community property interest of the predeceasing nonparticipant spouse in the participant's plan was not a probate asset because ERISA preempted state law. Finally —it was only a matter of time—, the Fifth Circuit was faced with the question.[46] The Fifth Circuit reached a conclusion contrary to the Ninth. This case was *Boggs v. Boggs*, a case that made its way eventually to the United States Supreme Court where the Fifth Circuit was reversed in 1997.

The *Boggs* Facts. This case was originally decided by applying Louisiana law, since the decedent and his wives lived and (with the exception of wife two who is still living) died in Louisiana. The decedent, Isaac Boggs, was an employee of South Central Bell from 1949 until he retired in 1985. Isaac Boggs was married to Dorothy Boggs when he began employment until Dorothy's death in 1979. Three children were born of this marriage. Dorothy's will gave her husband a usufruct interest (similar to a life estate) in two-thirds of her estate, with the remainder to go to her three sons. Mr. Boggs married Sandra Boggs in 1980, and died in 1989. In 1985, Mr. Boggs received a distribution of a portion of his retirement plan benefits, which he rolled over to an IRA. The opinion does not indicate whether this portion of the plan was subject to the joint and survivor annuity rules. If it was, then Sandra must have waived her rights, or the proceeds could not have been rolled over into an IRA. Of course, the IRA, presumably, would not have been subject to ERISA or to the joint and survivor annuity rules, in any event. Another portion of the Bell plan was distributed in the form of AT&T stock and a life insurance policy naming Sandra as the beneficiary. Finally, Isaac was receiving a joint and survivor annuity, to which Sandra succeeded at the time of his death.

The 5th Circuit Decision. The 5th Circuit, like the majority of the Supreme Court, made no real distinction between any of these benefit forms. This may have been appropriate, since when Dorothy Boggs died in 1979, Isaac's benefits were not in pay status. So, the form that the benefit payments actually took may have been irrelevant to the analysis of whether the Boggs children had rights in the benefits to begin with.

It is important to note that, unlike *Ablamis*,[47] this was not an action brought against the plan itself. Rather, the action was in the nature of an accounting against Sandra. One consequence of this posture was that it allowed the Boggs children to contend that the court lacked jurisdiction to decide the case. The court dispensed with this argument summarily. However, the Fifth Circuit did conclude that the children were entitled to the benefits in which their mother had a state law community interest, despite the preemption and the anti-alienation provisions of ERISA. **The United State Supreme Court, however, reversed.**

---

[45] *Ablamis v. Roper,* 937 F.2d 1450 (9th Cir. 1991).

[46] *Sandra Jean Dale Boggs vs. Thomas F. Boggs, Harry P. Boggs and David B. Boggs,* 82 F.3d 90 (5th Cir. 1996).

[47] *Ablamis v. Roper,* 937 F.2d 1450 (9th Cir. 1991).

Copyright 2000

Is *Boggs* Important? As recited in the facts of the Supreme Court opinion, "The nine community property States have some 80 million residents, with perhaps $1 trillion [that's with a "t"] in retirement plans." A billion here and a billion there, and pretty soon you're talking about real money.[48]

The Supreme Court Decision. In *Boggs v. Boggs,* 117 S.Ct. 1754, 138 L.Ed.2d 45, 65 U.S. L.W. 4418 (1997), five of the nine justices squarely held that Dorothy Boggs had no power to transfer at death her interest in her husband's undistributed benefits under a pension plan subject to ERISA. To the extent state law would have provided a contrary result, it is preempted. Further, citing *Free v. Bland,*[49] the state of Louisiana could not make an end run around the federal rule by seeking an accounting from Isaac Boggs' beneficiary, his new wife Sandra.

Free b. Bland.[50] *Free v. Bland* involved the right of a surviving spouse to succeed to an interest under a U.S. Savings bond held in joint tenancy with right of survivorship. At the time the case was decided, Texas law did not recognize joint and survivorship provisions between husband and wife in community property. The Supreme Court held that Texas law was preempted in this regard in the case of survivorship rights in United States Savings Bonds. **Further —and this is the point—, the effect of granting survivorship rights could not be circumvented by ordering that the community be reimbursed out of the owner's separate estate.**[51]

> Notwithstanding this [survivorship] provision, the State [Texas] awarded full title to the co-owner but required him to account for half of the value of the bonds gto the decedent's estate. Viewed realistically, the State has rendered the award of title meaningless. Making the bonds security for the payment confirms the accuracy of this view. If the State can frustrate the parties' attempt to use the bonds' survivorship provision through the simple expedient of requiring the survivor to reimburse the estate of the deceased co-owner as matter of law, the State has interfered directly with a legitimate exercise of the power of the Federal Government to borrow money.[52]

The Seven to Two Decision. Two of the otherwise dissenting judges (Rehnquist and Ginsburg) agreed with the five majority Justices to the extent that Sandra (the second wife) had rights guaranteed under ERISA as a result of the Retirement Equity Act (REA).[53] Therefore, they joined in Part III of the majority opinion, the part concerned solely with the surviving spouse's REA rights:

---

[48] A corruption of a statment of form Senator Everett Dirkson regarding budget appropriations, adjusted for inflation.

[49] *Free v. Bland***,** 369 U.S. 663, 669.

[50] *Free v. Bland***,** 369 U.S. 663, 669.

[51] *Free v. Bland,* 369 U.S. 663, 668-670, 82 S.Ct. 1089, 8 L.Ed.2d 180 (1962).

[52] *Free v. Bland,* 369 U.S. 663, 668-670, 82 S.Ct. 1089, 8 L.Ed.2d 180, 185 (1962).

[53] The Retirement Equity Act of 1984 (P.L. 98-397, Aug. 23, 1984).

Copyright 2000

> Even a plan participant cannot defeat a nonparticipant surviving spouse's statutory entitlement to an annuity. It would be odd, to say the least, if Congress permitted a predeceasing nonparticipant spouse to do so. Nothing in the language of ERISA supports concluding that Congress made such an inexplicable decision.

Point well taken! It is probable that the only reason the other two Justices (Breyer and O'Connor) did not join in Part III is that, under the facts, there was enough money involved so that Sandra (Wife number two) could have received her full undiminished annuity under REA, even if forced to give up Dorothy's portion out of the remainder. It would be astonishing if state community property law could effectively place a surviving spouse in an overall worse position than that minimally mandated by REA, without being preempted. In order to give effect to state law in this context, one must be able to say (presumably with a straight face) that even if state law deprives a surviving spouse of Congressionally mandated guaranteed benefits, the law does not "relate" to the plan that guaranteed those benefits.

The Five to Four Decision. In the words of the Court:

> **Beyond seeking a portion of the survivor's annuity, respondents claim a percentage of: the monthly annuity payments made to Isaac Boggs during his retirement; the IRA; and the ESOP shares of AT&T stock.** As before, the claim is based on Dorothy Boggs' attempted testamentary transfer to the sons of her community interest in Isaac's **undistributed** pension plan benefits. Respondents argue further--and somewhat inconsistently--that their claim again concerns only what a plan participant or beneficiary may do once plan funds are distributed, without imposing any obligations on the plan itself. **Both parties agree that the ERISA benefits at issue here were paid after Dorothy's death, and thus this case does not present the question whether ERISA would permit a nonparticipant spouse to obtain a devisable community property interest in benefits paid out during the existence of the community between the participant and that spouse.**
>
> * * * *
>
> We conclude the sons have no claim under ERISA to a share of the retirement benefits. To begin with, the sons are neither participants nor beneficiaries.
>
> * * * *
>
> Dorothy's 1980 testamentary transfer, which is the source of respondents' claimed ownership interest, is a prohibited "assignment or alienation."
>
> * * * *
>
> As was true with survivors' annuities, it would be inimical to ERISA's purposes to permit testamentary recipients to acquire a competing interest in undistributed pension benefits, which are intended to provide a stream of income to participants and their beneficiaries.
>
> * * * *

Copyright 2000

Respondents contend it is anomalous and unfair that a divorced spouse, as a result of a QDRO, will have more control over a portion of his or her spouse's pension benefits than a predeceasing spouse. Congress thought otherwise. The QDRO provisions, as well as the surviving spouse annuity provisions, reinforce the conclusion that ERISA is concerned with providing for the living. The QDRO provisions protect those persons who, often as a result of divorce, might not receive the benefits they otherwise would have had available during their retirement as a means of income. In the case of a predeceased spouse, this concern is not implicated. The fairness of the distinction might be debated, but Congress has decided to favor the living over the dead and we must respect its policy.

The axis around which ERISA's protections revolve is the concepts of participant and beneficiary. When Congress has chosen to depart from this framework, it has done so in a careful and limited manner. Respondents' claims, if allowed to succeed, would depart from this framework, upsetting the deliberate balance central to ERISA. It does not matter that respondents have sought to enforce their rights only after the retirement benefits have been distributed since their asserted rights are based on the theory that they had an interest in the undistributed pension plan benefits. Their state-law claims are pre-empted. The judgment of the Fifth Circuit is Reversed. [Emphasis added.]

The Undoubted Law. Five to four decision or not, we must assume that *Boggs* is now the law, and that if a plan is governed by ERISA, and if the nonparticipant spouse dies first, the community property interest of the nonparticipant spouse is not transferable to the spouse's beneficiaries. Further, a state court cannot rectify the situation indirectly by seeking an accounting or restitution or set off of the participant's other assets not in the plan. This much is clear.

Unresolved Problems in the Law *Post Boggs*.

Is the Nonparticipant's Interest to be Included as Part of the Nonparticipant's Estate If it Cannot Be Transferred? The answer to this question has marital deduction implications, among other things. It also affects the characterization of the asset at the time of the participant's death.

If the predeceasing nonparticipant spouse has no testamentary power to transfer his or her interest, should that interest be included in the spouse's estate. **According to PLR 8943006 the Service apparently thinks that the value of a spouse's community property interest in a plan is includible in the spouse's gross estate under §2039(a) <u>even if the spouse cannot dispose of the interest by testamentary disposition</u>, but had a beneficial interest in the plan prior to death.**[54]

PLR 8943006, citing *Allard*,[55] but relying on *Ablamis*[56] (*Boggs* had yet to be decided) and apparently misinterpreting Louisiana law, held:

---

[54]**PLR 8943006.**

[55]*Allard v.* Frech, 754 S.W.2d 111 (Tex. 1988).

Copyright 2000

> It appears that **no interest in W and H's pension benefits in the present case could have passed under W's will** or otherwise to W's children. Thus, W's community interest in the pension benefits passed to H by operation of law pursuant to the provisions of the joint and survivor annuity described in the plan.

The PLR concluded that—

> [T]he value of W's community property interest in the plan is includible in her gross estate under section 2039(a) of the Code.

In my opinion, §2039 is the wrong statute. I believe the Service failed to pay adequate attention to §2039(b). Even if §2039(a) would on its face cause inclusion, there is §2039(b) to consider:

> "(b) AMOUNT INCLUDIBLE-Subsection (a) shall apply to only such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent. For purposes of this section, any contribution by the decedent's employer or former employer to the purchase price of such contract or agreement (whether or not to an employee's trust for fund forming part of a pension, annuity, retirement, bonus or profit-sharing plan) shall be considered to be contributed by the decedent if made by reason of his employment."

The problem with treating the predeceased nonemployee's community property interest as includible under §2039 is that although it might be said that under §2039(a) the employee is a beneficiary who will receive an interest under the plan by reason of surviving the nonparticipant (assuming the interest cannot be disposed of by the nonparticipant), the amount includible is limited under §2039(b) to the proportionate value of the interest contributed by the decedent (in this case the decedent is the "nonemployee spouse") or by the decedent's employer. The decedent, in this case the nonemployee spouse, contributed nothing to the plan (at least not directly), and, for that matter, neither did the employee spouse (arguably). Why do I say the decedent contributed nothing? Because the decedent is not the employee. Why do I go further and suggest that the employee contributed nothing? Because technically it is the employer that makes the contribution, not the employee (ordinarily). It is the last sentence of 2039(b) that attributes contributions of the "decedent's" employer to the decedent.

If §2039 does not apply, what section does? §2041? **Not if the nonemployee has no power of disposition.** Under the *Boggs*[57] case, the nonemployee has no such power if the interest is under a plan subject to ERISA!

---

[56] *Ablamis v. Roper,* 937 F.2d 1450 (9th Cir. 1991).

[57] *Boggs v. Boggs,* 117 S.Ct. 1754, 138 L.Ed.2d 45, 65 U.S. L.W. 4418 (1997).

Copyright 2000

§2033? Whether or not the spouse can dispose of the interest by testamentary disposition, the Service has held that the interest is includible under §2033.[58] (§2041 would suffice to bar any argument if the spouse does have a testamentary power.) But under *Boggs*, as already mentioned, the spouse lacks this power. Moreover, if §2033 were sufficient to cause inclusion in the case of a nonemployee, it would presumably never have been necessary to enact §2039 to cover the employee's interest, now would it. It is because it is the employer, rather than the employee, that owns and operates and contributes to the plan that Congress felt compelled to enact §2039 in the first place; otherwise, §2033 would presumably have sufficed.

If the spouse lacks the power to transfer the interest, it is arguable that the interest is not includable in the estate, as a matter of Constitutional law, since the estate tax is an excise tax on the power to transfer property. If it were a direct tax, other than an income tax, it would be prohibited by the Constitution unless apportioned in accordance with the census:

> "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[59]

The example I have heard used is that if an individual owns the formula to make Coca Cola™, and, instead of transferring the formula to someone at death, instead instructs the executor to burn it, the value of the formula is not includible in the gross estate for estate tax purposes because it is not being transferred. This is also the reason that a burial plot is not taxed.

On the other hand, in all candor, there is arguably a transfer of the qualified plan interest; it is just that it is not a transfer by the spouse. This is unlike the Coca Cola™ or burial plot example, in this perhaps important respect.

If the Nonparticipant's Interest Is Includible in the Nonparticipant's Estate, Does it Qualify For the Marital Deduction? It is clear that a marital deduction will not be available if the interest is a nondeductible "terminable interest." What is a terminable interest? A "terminable interest" in property is:

> "An interest which will terminate or fail on the lapse of time or on the occurrence or the failure to occur of some contingency. Life estates, terms for years, annuities, patents, and copyrights are, therefore, terminable interest."[60]

A property interest which constitutes a terminable interest is non-deductible if:

> "(i) another interest in the same property passed from the decedent to some other person for less than an adequate and full consideration in money or money's worth, and

[58]Rev. Rul. 67-278, 1967-2 C.B. 323. Made obsolete by 88-85. *Cf.* PLR 8943006.

[59]U.S. Constitution, Article I, Sec. 9.

[60]Treas. Reg. §20.2056(b)-1(b).

(ii) by reason of its passing, the other person or his heirs or assigns may possess or enjoy any part of the property after the termination or failure of the spouse's interest."[61]

Under a qualified plan, an interest that passes from the nonparticipant spouse to the participant will terminate or fail if the participant remarries, since, under that "contingency," the new spouse would have REA survivorship rights. The interest that would pass to the new spouse would pass for less than full consideration and by reason of its passing the new spouse may "enjoy any part of the property after the termination or failure of the spouse's interest." I am tempted to say at this point, "**Draw your own conclusions!"** , but before doing so, consider IRC §2056(b)(7)(C).

Does 2056(b)(7)(C) Apply to the Nonparticipant's Interest "Passing" to the Participant? IRC §2056(b)(7)(C) does not require that all of the income be payable to the surviving spouse in order to obtain a marital deduction under the QTIP (qualified terminable interest property trust) rules, but only requires that no payments can be made to the surviving spouse so long as the spouse is living:

> **(C) Treatment of survivor annuities.--**In the case of an annuity included in the gross estate of the decedent under section 2039 *(or, in the case of an annuity arising under the community property laws of a State, included in the gross estate of the decedent under section 2033)*[62] where only the surviving spouse has the right to receive payments before the death of such surviving spouse--
>
> (i) the interest of such surviving spouse shall be treated as a qualifying income interest for life, and
>
> (ii) the executor shall be treated as having made an election under this subsection with respect to such annuity unless the executor otherwise elects on the return of tax imposed by section 2001.
>
> An election under clause (ii), once made, shall be irrevocable.

Is this section meant to apply to the nonparticipant? The addition of the italicized language by the Taxpayer's [Sigh] of Relief Act makes it clear that answer is now clearly yes. Moreover, the IRS apparently believes that it was not so intended originally.[63] The only problem with §2056(b)(7)(C) in this context, as originally enacted, is that it required that the interest be includible under §2039, which is of dubious application in view of §2039(b) as argued above.[64]

---

[61]Treas. Reg. §20.2056(b)-1(c)(i).

[62]The italicized parenthetical language was added by the Taxpayer's [Sigh of] Relief Act, P.L. 105-34 1997, §1311(a) effective for estates of decedents dying after August 5, 1997.

[63]PLR 8943006 indicates that the IRS thinks it has always applied to the nonparticipant.

[64]Another problem, which we will conveniently ignore, is that on the contingency of remarriage followed by divorce, the QDRO rules would permit a subsequent spouse to succeed to the interest of the participant during the participant's life, but I suppose this would be true of any gift.

Copyright 2000

The recent amendment shifts the focus from §2039 to §2033. As previously discussed, it is arguable that §2033 can not apply to an asset that the decedent (in this case the nonparticipant spouse) **did not and cannot transfer**.

What is the Interest of the Participant, On the Participant's Death. If the participant inherited an interest from the spouse by virtue of the automatic QTIP treatment mandated by §2056(b)(7)(C), first sentence, flush parenthetical language, then inclusion in the participant's estate would be under §2044, for whatever difference that makes. If forwhatever reason, the nonparticipant spouse does not get a marital deduction, is the nonparticipant's interest included in the participant's estate, if the participant dies last, and if so, under what statute?

If the participant survives the nonparticipant, and if §2044 is inapplicable, we could theoretically have inclusion under §2041, if that the participant has the power, at any time (including death), to appoint the interest to himself, herself, or to his or her estate or creditors. That right may come at some point, but won't exist during lifetime (ordinarily) prior to retirement; and again, if the participant remarries, the right might never exist. Ponder that, if you will.

If the participant predeceases the nonparticipant, it would be reasonable to assume that if the participant can appoint the property to creditors or the estate, then 2041 would apply here too. As previously discussed, the participant can probably appoint all sole management community property to creditors or the estate, *at leaset* to the extent that REA does not give the spouse an inalienable interest. In the context of a qualified plan, the participant cannot appoint the nonparticipant's interest to creditors or the estate, to the extent the surviving spouse has REA rights. It is worth noting that the Service has never raised the 2041 specter in other cases involving conventional sole management community property (thank goodness) —perhaps because if 2041 applied an offsetting 2053 deduction would be available (to which my comment is: not necessarily).

If Pension Benefits Subject to ERISA are Distributed During the Lives of Both Spouses, Will the Nonparticipant Spouse Then Have a Testamentary Power of Disposition? This is the $64,000[65] question. My opinion is that the spouse will have such a power. I suppose that what to me would be a nightmare scenario of ERISA preemption never going away, haunting the recipient like a specter for so long as the assets distributed can be traced, could be a good thing, depending on one's perspective. But it will make estate planning for the medium sized estate much more difficult than it already is.

I assume that once pension benefits are distributed they are alienable, and can be reached by creditors. On divorce, one also assumes that the QDRO rules need not be complied with respect to plan benefits that have already been distributed, which is helpful, since in that case the QDRO rules could not be complied with and in that context do not make sense.

[65]Unadjusted for inflation.

One could argue that if the beneficiaries of a predeceased nonparticipant spouse step into the spouse's shoes, and yet, upon ultimate distribution from the plan they are not entitled to the share of the benefits that the predeceased spouse would have been entitled to if living, then it follows, as a matter of very compelling logic, that the fact that the spouse outlived the distribution ought not to be of special relevance. Indeed, the majority opinion in the Boggs case suggests that this could be an issue for future resolution:

> Both parties agree that the ERISA benefits at issue here were paid after Dorothy's death, and thus **this case does not present the question whether ERISA would permit a nonparticipant spouse to obtain a devisable community property interest in benefits paid out during the existence of the community between the participant and that spouse**.

This is a rather ominous comment. It is worth noting at the onset that if, in fact, plan proceeds are always protected against testamentary transfer by the spouse, even after distribution, we will be faced with an accounting nightmare for which most work-a-day participants and their lawyers will be generally unprepared. In such a case, it would matter not whether the interest were placed in a rollover IRA, a shoebox, a passbook savings account, or invested in the stock market, it would still be treated as the participant's separate property, in effect. (Presumably the income on the distribution would be transferable by the nonparticipant spouse without regard to preemption issues.)

My own opinion is that when next faced with this question the Supreme Court will back away from an extension of *Boggs*, and will give common sense precedence over strict logic. This is, after all, not unknown at the Supreme Court level. It has been observed so frequently by so many that it is by now a commonplace (and even if you are not a lawyer you've probably noticed) that the Supreme Court will often do what it thinks is the right thing, whether or not strictly called for by the law. Though I think the practice insidious in general, here the Court frequently has no choice but to give policy its due, within limits, simply because if "relate to" were literally the test, everything would be preempted, because everything relates to everything else (at least according to philosophers and physicists).

There are in fact good legal reasons for making a distinction between those cases where the nonparticipant dies prior to a distribution and those cases where death occurs later. The majority opinion was based largely on the anti-alienation provision of ERISA §206(d), the IRC corollary of which is §401(a)(13). I am not aware of any cases holding that the anti-alienation rule survives a distribution of plan assets. One may surely transfer pension plan benefits that have been distributed, as surely as one is prohibited from transferring benefits that have not.

Technically, a testamentary "**transfer**" takes place takes place at death, if successful. **It is reasonable to interpret *Boggs* as involving an attempted "transfer" at death by Dorothy Boggs of plan assets, a transfer clearly prohibited by ERISA §206(d)!** However, once the assets are no longer in the plan, the anti-alienation rule would not prohibit the transfer. Therefore, if the nonparticipant spouse makes a testamentary "transfer" of the assets after they have been distributed, there is no longer any ERISA impediment to the alienation, or so I would argue. True, Dorothy's children made much the same argument by contending that although the transfer at death was admittedly ineffectual at that time, it ought to be given effect after death, when and

Copyright 2000

if the assets are distributed. My response is that this is like arguing that I am entitled to irrevocably assign you my interest in my pension plan now, as long as it is understood that you are to receive those benefits only when distributed by the plan. There is no question whatsoever that any attempt to do this would be ineffectual in addition to being prohibited.

Given the vigorous nature of the dissent in *Boggs*, and the desirability of limiting it to undistributed pension benefits only, **I think it all but certain that at least one additional Justice will join the four dissenting Justices that did not agree with *Boggs* to begin with, and if faced with the question would decide that *Boggs* only applies to benefits that were undistributed at the time of the nonparticipant's death.** This is simply the most practical solution to the problem, even if a rigorously logical (hidebound?) extension of *Boggs* would make no distinction as to whether death occurs before or after distribution.

How Does *Boggs* Affect Estate Planning? I agreed with the result in *Boggs,* not because I think it a desirable outcome, but because I could not see how one could, in good conscience, argue that state law, if allowed to operate unfettered, would not "relate" to an employee benefit plan when it deprives both the participant and the participant's (new) spouse of rights specifically granted under the federal law. I say this being mindful of state's rights concerns, with which I am generally sympathetic; but whatever my personal opinion, I cannot ignore the commerce clause either.

One reason I think that ERISA preemption in this area is unfortunate is that it will interfere with bypass trust planning for all but the very wealthy and the very not so wealthy. Persons with combined estates under $625,000, and persons with combined estates of over $1.2 million exclusive of qualified plan benefits, may not be affected much by *Boggs*. But the many people in between may be unable to shelter the unified credit exemption equivalent (approximately $625,000) without resorting to the assets in a qualified plan. And if the nonparticipant spouse dies first, *Boggs* says that these benefits are unavailable for that purpose if subject to ERISA.

Possible Solutions to the Boggs Dilemma. If the pension plan assets are distributed, the problem goes away —that is, it goes away unless the logic of *Boggs* is extended to transfers taking place after distribution. If the assets are distributed, they could be rolled into an IRA. IRAs are not subject to ERISA —again, unless the logic of *Boggs* is unreasonably extended, which it presumably will not be. Life insurance is certainly a viable solution here if the nonparticipant is healthy and not too old.

Copyright 2000

Are There Other Reasons, Besides *Boggs*, for Rolling Qualified Plan Benefits Into an IRA? There are other reasons besides *Boggs* for getting assets out of a qualified plan and into an IRA. True, qualified plans can permit loans, the investment of plan assets in life insurance, and in a few cases 5/10 year forward averaging can produce an income tax savings at the expense of long term deferral. (IRAs are exempt from creditors under Texas law, just as qualified plans are exempt under ERISA, so this is not of great concern.) There are, however, advantages afforded by an IRA that are not available under a qualified plan. One very important advantage an IRA has over a qualified plan is that an IRA does not require a plan sponsor. If the plan sponsor goes out of business, or the plan is terminated by the sponsor, a non spouse beneficiary is not permitted to rollover plan benefits and will face the prospect of immediate income taxation. This cannot happen in an IRA. Another advantage —at least to the participant— is that an IRA is not subject to the spousal annuity rules of REA, and this permits a great deal more estate planning flexibility.

Conclusion. In estate planning for married persons, one must be mindful that qualified plan and IRA benefits are likely to be made of community property in whole or in part. If the interest is subject to ERISA, federal law will preempt state community property law to an extent that in many contexts can be uncertain. These considerations are going to affect bypass trust planning and marital deduction planning, among other things. In any event, one must consider:

- Are we planning the participant's estate, or the nonparticipant's estate?
- Is the interest involved community property, and if so, to what extent?
- Does ERISA preempt state community property law, and if so, what can be done about it?
- Will the nonparticipant's interest pass to the participant or to a trust for the participant, or to someone else entirely?
- If the nonparticipant's interest does not pass to the participant (e.g., it passes to a bypass trust for the participant), when must it be distributed and what are the tax consequences upon distribution?

These are just a few of the many considerations confronting a person doing estate planning for persons with large community property interests in a qualified plan or IRA.