COMMUNITY PROPERTY

A. Introduction.

In a community property state the non-participant spouse is generally deemed under state law to own a share of the participant spouse's interest in a qualified retirement plan or IRA. This section will analyze the rights of the respective spouses (and their estates) while the community is intact and after it is dissolved. Particularly vexing questions arise when the community is dissolved by the death of the non-participant spouse.

This section is relevant not only for those married persons who now live in a community property state but also for any couples who in the past have accrued benefits under a qualified retirement plan or IRA while living in a community property state.

The rules for qualified retirement plans are significantly different from the rules for IRAs; therefore, most of the following sub-sections discuss qualified retirement plans and IRAs separately. To avoid confusion it will be assumed that the husband is the spouse who is the participant in the qualified retirement plan or the record owner of the IRA. Also, the term “participant” will be used to refer to the participant in the plan or the record owner of the IRA.

B. State Law and Federal Preemption

1. Qualified Retirement Plans.

As a general rule, the benefit accrued by a married person in a qualified retirement plan who lives in a community property state will be characterized as community property under the laws of that state. A portion of a participant's benefit may be community property and a portion separate property if the participant lived part of the time in a separate property state and a part of the time in a community property state, or was only married during part of the time that he accrued the benefit. It should be noted, however,

that in some of the community property states the principles of "quasi-community property" may apply upon the termination of the community while domiciled in that state. Under those principles a benefit accrued during the marriage while living in a separate property state may be characterized as community property if it would have been so-characterized if it had been earned while living in the community property state. To the extent that the interest in the qualified retirement plan is classified as community property, distributions from the plan will also be considered community property.

Federal law does not preempt community property in the case of divorce or the death of the participant spouse. However, as discussed below at Section C.4, the U. S. Supreme Court, in *Boggs v. Boggs*, 117 S.Ct. 1754 (1997), has held that ERISA preempts in the situation when the non-participant spouse dies owning a community property interest in a qualified retirement plan. In that situation according to *Boggs* the interest of the non-participant spouse automatically passes to the participant spouse.

Retirement plans for employees of the United States are creatures of Federal law and, therefore, the state law of community property will apply to benefits under such plans only to the extent permitted by the governing Federal law. Generally the statutes do authorize the application of community property principles, at least in some circumstances. See, e.g., 10 U.S.C. 1408(c)(1) (military pensions), and 5 U.S. C. 8345(j) (civil service pensions).

2. IRAs.

The community property states classify IRAs as separate or community property in a manner similar to the way qualified retirement plans are classified. To the extent that an IRA is funded by rollover from a qualified retirement plan, under state law the IRA will normally be community property to the same extent as was the participant spouse's interest in the plan.

IRAs are subject to fewer statutory requirements than qualified retirement plans, and ERISA (with its preemption provision) generally does not apply. Therefore, it appears that ERISA and the Code impose

no objection to applying state community property principles to IRAs in all respects. It is believed that this applies to rollovers from qualified retirement plans as well, despite the *Boggs* case.

The section of the Internal Revenue Code describing IRAs does contain one wrinkle that does not appear in the rules governing qualified retirement plans. Code Section 408(g) states that "this section [setting out the requirements for IRAs] shall be applied without regard to any community property laws". It is widely believed by practitioners, and by the IRS, that this provision means only that community property is ignored in applying the limitations on IRA contributions that are set forth at Code Section 219. See, e.g., PLR 8040101, 9630034.

Furthermore, the courts have almost uniformly proceeded on the assumption that IRAs are subject to state community property law. See, e.g., <u>Estate of Margery M. MacDonald v. Robert F. MacDonald</u>, 794 P. 2d 911 (Cal. 1990), <u>Succession of Egan</u>, 543 So.2d 940 (La. App. 1989).

3. Disposition at Death.

a. Participant Spouse Dies First.

In the case of qualified retirement plans, Code Section 401(a)(11) generally requires that the beneficiary be the surviving spouse unless the surviving spouse has consented to the designation of a different beneficiary. In that way, the non-participant spouse is assured of receiving her community interest and then some.

No such requirement applies to IRAs. Therefore, as a matter of contract law between the participant spouse and the IRA custodian or trustee, the participant spouse can name anyone as beneficiary of 100% of the benefit. And state law may protect the custodian or trustee if it pays pursuant to that designation. See, e.g., La. R. S. 9:2449.

Nevertheless, if the non-participant spouse has a community property interest in the IRA the non-participant spouse will probably be able to make a claim under state law against the recipient from the IRA

or, if payment has not yet been made from the IRA, may be able to assert a claim with the custodian or trustee that will prevent payment of her share of the IRA to the designated beneficiary.

In some community-property states it is possible to combine retirement plan benefits and IRAs with the assets of a revocable trust in order to divide the community on an aggregate basis, with the surviving non-participant spouse generally receiving full ownership of those benefits, and the other community assets remaining in trust for the deceased spouse's beneficiaries. See, e.g., PLR 199925033.

b. Non-Participant Spouse Dies First.

If the non-participant spouse is the one who dies first owning an interest in a qualified retirement plan, the non-participant spouse has no power to dispose of her interest, and the participant spouse becomes the full owner, by virtue of the *Boggs* decision.

In the case of an IRA, however, Federal law does not prevent the non-participant spouse from being able to dispose of her community property interest. And state law now generally affirms that the non-participant spouse's community interest survives her death. The laws of the State of Washington were recently amended to assure that result. See RCW 6.15.020(6).

The disposition by the non-participant spouse of her community interest is generally accomplished under state law by means of the non-participant spouse's Will. It may be possible under state law to provide in an individually-designed IRA regarding the disposition of the non-participant spouse's interest at death.

Unfortunately, there is very little experience in the several community property states as to what steps the estate (or heirs or legatees) of the non-participant spouse should take to assert the decedent's interest in the IRA. Since the payment out of the IRA immediately to the estate would trigger immediate recognition of taxable income on the full amount (if not a Roth IRA) it may be desirable to retain the full

amount of the benefit in the IRA. One way to do this may be for the participant to cooperate in carving out the non-participant spouse's interest into a separate IRA in the name of the participant.

There are also some unknowns regarding the income tax treatment of the payments from the IRA to the heirs or legatees of the non-participant spouse. Generally speaking all payments from an IRA in the name of a participant are taxed to that participant. If, however, it can be demonstrated that the payments are made to an individual other than the participant who is in fact the owner of the IRA, there is some authority for the concept that the recipient should be taxed rather than the participant. See, e.g., PLR 8040101. It is possible, however, that without more reliable authority IRA custodians or trustees will be reluctant to issue 1099s to the recipient rather than the participant.

C. Asserting the Non-Participant Spouse's Community Interest Against Qualified Retirement Plans.

Under the Code and ERISA the participant spouse in a qualified retirement plan is generally the only person during his life who has a right to receive benefits accrued in his name. Under Code Section 401(a)(13) the participant cannot assign his or her rights nor can a creditor seize them. And, of course, the provisions of ERISA "supersede any and all state laws insofar as they . . . relate to any employee benefit plan. . .". Thus, it appears that in order for the non-participant spouse's interest to be recognized, such recognition must be permitted by ERISA and the Code or must be allowed under a state law that is not pre-empted by ERISA.

Prior to 1984, neither ERISA nor the Code expressly addressed community property rights in qualified retirement plans. During those years, in cases involving divorced spouses, several courts held that community property rights were not pre-empted; thus a court order on behalf of the divorced spouse could be enforced against the qualified retirement plan. See e.g., Stone v. Stone, 632 F.2d 740 (9th Cir. 1980),

cert. denied, 453 U.S. 922 (1981). Allard v. Frech, 754 S.W. 2d 111 (Tex. 1988), even gave the non-employed spouse's heirs rights against the plan.

Moreover, several IRS rulings specifically authorized payments to divorced spouses as not being in violation of the Code, provided the benefit was in pay status. The claim was allowed because it was based on ownership and not a creditor's claim. See, e.g., PLR 8125097, 8027041, and 7952045.

In 1984, Congress adopted the Retirement Equity Act ("REA"), which amended both ERISA and the Code to describe the circumstances in which a non-participant spouse can assert her community property rights against the qualified retirement plan. The spouse must obtain a qualified domestic relations order ("QDRO"). As defined at Code Section 414(p) and ERISA Section 206(d)(3), a "domestic relations order means any judgment, decree or order (including approval of a property settlement agreement) which . . . is made pursuant to a State domestic relations law (including a community property law)". The requirements for a QDRO are further described in Section V.B of this Study. If a court order does not meet the technical requirements for a QDRO, the order will be ineffective against the qualified retirement plan.

1. The Consequences of QDROs.

Payments made to an alternate payee who is the spouse or former spouse are taxed to the alternate payee. Code Section 402(e)(1)(A). By implication, payments to other alternate payees are taxed to the participant, probably because Congress assumed that such payments would always be in satisfaction of the participant's support obligation.

Several special tax benefits are enjoyed by the non-participant spouse who receives benefits pursuant to a QDRO:

- Lump sum payments can be rolled over to the spouse's own IRA. Code Section 402(e)(2).

- If the participant could elect income averaging as to his benefit, if paid to him in a lump sum, the spouse or former spouse can elect income averaging as to her share if received in a lump sum. Code Section 402(e)(4)(D)(vii).
- Payments made pursuant to QDRO are not subject to the 10 percent tax on premature distributions. Code Section 72(t)(2)(C).

2. QDROs in Connection with Divorce.

Through REA, Congress clearly intended to allow community property rights to be recognized against a qualified retirement plan in a divorce context.

The form of benefit required by the QDRO must be permitted under the plan, and the QDRO cannot require the benefit to be paid prior to a time when the plan would permit. A special rule allows requiring immediate distribution to the alternate payee if the participant spouse is over 50 and the plan would permit an immediate distribution if he terminated employment. Code Section 414(p)(4).

Thus, QDROs generally contemplate that the non-participant spouse will receive her share only when the participant receives his. This is not, however, a necessary result. The Code allows a qualified retirement plan to permit immediate distribution of the non-participant spouse's share pursuant to QDRO, even if by law the participant himself cannot receive any benefit at the time. Code Section 414(p)(10).

The procedure for awarding an alternate payee an interest in a qualified retirement plan varies from state to state, and qualified retirement plans vary widely in terms of the ability of the alternate payee to receive an immediate payout, and what the available forms of benefit are.

If the participant spouse controls the plan, the divorce settlement might include an agreement by the participant spouse to amend the plan to allow a QDRO to direct an immediate distribution of the amount due the non-employed spouse. In this way, the non-participant spouse's claim can be promptly resolved.

Taking an immediate distribution also avoids possible loss of rights if the alternate payee dies before receiving the full amount of her benefit. The provisions of REA that describe QDROs do not expressly provide for inheritance and do not elevate the spouse named as the alternate payee under the QDRO to the full status of a participant. Thus, it is by no means certain that the rights of an alternate payee are heritable.

Indeed some features of the statutory scheme imply an intent that the rights of an alternate payee not be heritable. For example, as mentioned, Code Section 402(e)(1)(A) appears to tax to the participant spouse any payment made under a QDRO to anyone other than the non-participant spouse or former spouse. If courts should find that QDRO payments to an alternate payee's heirs or legatees were indeed contemplated, in order to prevent a grossly unfair tax result the courts would also somehow have to find that Congress in Section 402(e)(1)(A) did not mean to tax such payments to the participant.

In many circumstances, an immediate distribution pursuant to a QDRO will not be allowed by the plan. In these cases it may be in the best interest of both spouses if the non-participant spouse surrenders her interest in the qualified retirement plan in exchange for a greater share of other community assets. If it should be necessary to divide plan assets through a QDRO without an immediate distribution, the QDRO should specify what will happen if the non-participant spouse dies before receiving all of her share, in case her rights are heritable or she is deemed to have the power to name a beneficiary.

3. QDROs During Marriage.

Under REA, a spouse (not just a former spouse) can be an alternate payee, and a QDRO can be rendered pursuant to a "domestic relations law (including community property law)." Is it possible, then, for a married couple, in the absence of a dispute between them, to obtain a court order (perhaps an order ratifying a partition of the community property), and to have that order recognized as a QDRO? Such a QDRO would allow the spouses to obtain the significant tax benefits available to alternate payees. Such

a QDRO would also provide a solution to the estate-planning problem presented by Boggs. It is not likely that Congress meant for such an order to qualify as a QDRO. Furthermore, the Department of Labor has taken the position that only a court order in a domestic relations context can be recognized as a QDRO. See DOL Opinion Letters 90-46A and 90-47A.

4. Claims by the Estate of the Non-Participant Spouse.

An issue of great concern for community property estate planners has been the question of whether the non-participant spouse, dying before the participant spouse, can dispose of her community property interest in a qualified retirement plan to the detriment of the participant spouse.

The changes in ERISA made by REA indicated that a claim by the non-participant spouse's estate against the plan itself would fail. Such a probate order does not qualify as a QDRO; therefore, a qualified retirement plan would be forbidden to make payments pursuant to the probate order. In 1991, the 9th Circuit Court of Appeals, in *Ablamis v. Roper*, 937 F.2d 1450 (9th Cir. 1991), confirmed that position: the probate order in the non-participant spouse's estate was held not to be enforceable against the plan.

Ablamis v. Roper left open the question of whether the heirs or legatees of the deceased non-participant spouse could assert the deceased spouse's community property interest outside the plan, that is, against the participant or his death beneficiary who receive the benefits from the plan. In other words, did ERISA preempt only the claim against the plan, or did it entirely eliminate the rights of the community spouse? That question was answered by the U. S. Supreme Court in 1998 in *Boggs v. Boggs*, 117 S.Ct. 1754 (1997).

In *Boggs*, a slim majority of the Supreme Court held that to allow an indirect claim by the estate of the non-participant spouse would defeat the legislative intent to provide benefits under qualified

retirement plans only for the participant or his beneficiary. Thus, in the circumstances of the non-participant spouse's death, the community property interest of that spouse disappears.

It must be noted that *Boggs* did not hold that there is no such thing as a community property interest in a qualified retirement plan. The court could not reach that result, since the QDRO rules expressly provide for recognition of community property interests in the case of divorce. The court only held that, in the unique situation where the non-participant spouse dies owning an interest under community property principles in the qualified retirement plan of the surviving spouse, the community property interest either disappears or passes entirely to the participant.

Therefore, there is every reason to believe that community property principles continue to apply when the participant dies first, or when the participant receives the benefit from the qualified retirement plan prior to either spouse's death. If the participant rolls over the qualified retirement plan interest to an IRA while both spouses are living, it is very likely that the *Boggs* rule will not apply upon the later death of the non-participant spouse.

D. IRAs.

IRAs are not "plans" that are subject to ERISA. Thus, ERISA's preemption of state law does not apply. As discussed in section B.2 of this chapter, it is believed that the statement at Code Section 408(g) that Section 408 is "to be applied without regard to any community property laws" is not intended to preclude community property ownership under state law.

Furthermore, the Code contains no prohibition against paying IRAs to third parties. The QDRO rules do not apply to IRAs. Thus, payments out of IRAs can be made to third parties more freely than can payments out of qualified retirement plans. As pointed out in the following paragraphs, however, there can be tax drawbacks to such a payout.

1. Divorce.

A QDRO is not needed to partition an IRA upon divorce. Pursuant to Code Section 408(d)(6), any transfer of an IRA interest to the non-participant spouse in connection with a divorce suffices to make that IRA interest hers, and she can roll it over to her own IRA, deferring the income tax. The 10% tax on premature distributions is avoided by the rollover, but distributions from the rollover IRA prior to the non-participant spouse's age 59-1/2 could trigger the tax.

2. During the Marriage.

A participant is free to transfer IRA funds to his spouse during the marriage if he first withdraws the funds. The IRA, however, cannot be put in the non-participant spouse's name. If title to the funds is transferred to her free of the IRA, there will be immediate recognition of taxable income, and possibly the 10 percent excise tax on premature distributions.

3. Death of the Non-Participant Spouse.

As discussed at Section B.3.b. of this Chapter, State and Federal law generally allow the estate to inherit and claim the non-participant spouse's interest in the IRA. However, there are uncertainties regarding the ability to collect from the trustee or custodian of the IRA, and uncertainties as to whether the participant or the recipient will be taxed as benefits are paid from the IRA to the estate (or legatee) of the non-participant spouse, and whether the 10% excise tax will be assessed. Some planning ideas are discussed at Section F.2.b., below.

E. Gift and Estate Taxes.

1. When Participant Spouse Dies First.

Upon the death of one of the owners of an item of community property, normally only half of the item is includable in that spouse's gross estate for federal estate tax purposes.

If the non-participant spouse having a community property interest is also the sole death beneficiary, normally no transfer tax will be due at the death of the participant spouse, on the participant spouse's share

(thanks to the marital deduction under Code Section 2056), or on the non-participant spouse's share (because she has not transferred any ownership rights).

If the two spouses are still married at the participant's death and the death beneficiary is someone other than the non-participant spouse, the non-participant spouse is at risk of being deemed to have made a taxable gift of her community share of the benefit.

In the case of a qualified retirement plan, distribution to a beneficiary other than the non-participant spouse can happen only if the non-participant spouse has waived the right to be the death beneficiary. Code Section 2503(f) provides that the waiver by the non-participant spouse of the statutory right to be the death beneficiary under a qualified retirement plan does not in itself amount to a taxable gift. But Section 2503(f) does not exempt from gift tax the transfer that results when the non-participant spouse's ownership interest passes to a third party. By consenting to the naming of a third party as beneficiary, the non-participant spouse may be considered to have made a gift when her share passes to the beneficiary on the participant's death.

An interesting question with respect to qualified retirement plans is the disposition of a *divorced* surviving spouse's community interest when she has failed to obtain a QDRO during the participant spouse's life and is not named as the beneficiary. It is believed that a QDRO can be rendered by the participant spouse's estate, allowing the surviving ex-spouse to receive her community share despite not being named as the beneficiary. If she fails to obtain such an order then again she is at risk of being deemed to have made a taxable gift to the beneficiary.

In the case of an IRA, the spouse who is not the designated beneficiary should assert her community rights against the designated beneficiary or, depending on state law, against the IRA trustee or custodian. A failure to assert the claim may result in her having made a taxable gift of her interest.

2. When the Non-Participant Spouse Dies First.

Under *Boggs*, the non-participant spouse may have no ability to convey her community property interest in a qualified retirement plan; the participant spouse normally becomes full owner. Therefore, no estate tax will be due by the non-participant's estate. That result is justified by either of two rationales: either at death the non-participant spouse no longer has an interest to convey; or her interest passes by law to the participant spouse and, therefore, qualifies for the marital deduction. In the former case the interest is not included on the 706; in the latter case it is included on Schedule F, and a matching deduction is shown on Schedule M. The IRS has not yet stated a preference.

In the case of an IRA, the one-half community property interest of the non-participant spouse is an asset of her estate and will be subject to estate tax if it does not qualify for the marital deduction.

F. Estate Planning.

Estate planning with any retirement benefits and IRAs is a complicated matter. When the retirement benefits or IRAs are community property under state law, the complications multiply. The following are some thoughts about the disposition of the participant spouse’s interest and the non-participant spouse’s interest.

1. Participant's Designation of Beneficiary.

Typically, a married person names his spouse as the primary beneeficiary of his qualified plan or IRA. Community property adds a further reason for designating the surviving non-participant spouse as the primary beneficiary: if the non-participant spouse is not the beneficiary, she could be deemed to have made a taxable gift of her portion of the community interest that passes to another beneficiary.

There are situations, however, when the participant spouse wants his interest to pass other than outright to the surviving spouse. This would be normally when the participant spouse's unified credit would not otherwise be fully used. However, even in those cases the spouses usually want the non-participant spouse to receive her community interest outright, both to avoid her being deemed to have made a taxable gift, and so that she can roll over her interest to her own IRA and continue the tax deferral for a longer period of time. In those circumstances, it is desirable to structure the beneficiary designation so that the beneficiary of some or all of the participant spouse's interest in the qualified retirement plan or IRA passes to a by-pass trust, while the interest of the non-participant spouse passes outright to her.

Instead of making the by-pass trust the primary beneficiary of a portion of the benefit, more flexibility is achieved by naming the surviving spouse as the primary beneficiary, with provision for payment to a by-pass trust to the extent that the non-participant spouse disclaims that benefit. See, e.g., PLR 9630034.

An even better result can be achieved by means of the aggregate approach to the division of the community, if permitted under state law. If the community includes assets (exclusive of qualified retirement plans and IRAs) that are appropriate to hold in trust and that have a total value at least equal to the amount that the parties desire not to qualify for the marital deduction, then the parties should arrange to cause 100% of those assets to go to the by-pass trust while 100% of the qualified plans and IRAs go to the surviving spouse. This maximizes the rollover possibilities, which of course extends the time when the benefits have to be paid out and taxed.

There is some authority for the possibility of partitioning an IRA during the lives of the spouses and providing different death beneficiary provisions as to each IRA. See, e.g., PLR 9439020. Unfortunately the IRS will rule favorably on such an arrangement only if both IRAs, even the one now owned by the non-participant spouse, remain in the name of the participant spouse. The spouses' mutual rights would be

governed by a side agreement. Of some concern is the fact that the IRS has refused to rule as to whether such a transaction constitutes a prohibited transaction. In the unlikely event that the arrangement was considered to be to a prohibited transaction, the IRAs would no longer qualify for tax deferral, a highly unpleasant result.

2. Disposition of Non-Participant Spouse's Interest.

a. Qualified retirement plans.

If the interest involved is an interest in a qualified retirement plan, under the *Boggs* case the non-participant spouse has no disposable interest. If the spouses' wealth is concentrated in the qualified retirement plan of the participant spouse, so that there is a risk that the non-participant spouse's unified credit will not be availed of if she dies first, it will be highly desirable (where possible) to withdraw the benefit from the qualified retirement plan and roll it over to an IRA. It is believed that *Boggs* would not apply upon the non-participant spouse's death after the rollover.

Two schemes, neither of which is tax-tested, have been suggested to overcome *Boggs* when it is impossible or undesirable to withdraw funds from the qualified retirement plan. Rogers, Christensen and Cochran, “Overcoming the *Boggs* Dilemma in Community Property States”, The Tax Adviser, at 584 (August 1999) and 664 (September 1999), suggest that the non-participant spouse sell her community interest in the plan to the participant spouse in exchange for a note. Thus, at the death of the non-participant spouse a note rather than a plan interest is in her estate.

A second technique would be, if possible under state law, to partition the assets or enter into property agreements, so that the participant spouse receives 100% of the qualified retirement plan and the non-participant spouse receives 100% of other community assets.

b. IRAs

With respect to IRAs, in most if not all community property states the non-participant spouse has a disposable interest, and Federal law does not preempt state law. In many community property states the interest of the non-participant spouse is disposed of by Will. An individually-designed IRA might, if permitted by state law, allow the non-participant spouse to name her successor.

Although Federal law does not preempt state law there are a number of Federal law issues with respect to the disposition of the non-participant spouse's interest in the IRA to someone other than the participant spouse: How does the heir or legatee assert the claim against the IRA? Who is taxed on the payment? Is the payment at the direction of the non-participant spouse a prohibited transaction?

Plainly, in most cases it is desirable to avoid complications and arrange for the non-participant spouse to leave her community interest in the IRA outright to the participant spouse. If it is necessary to use a portion of the IRA to fund the non-participant spouse's unified credit, the Will (or other dispositive document) might give the interest to a credit shelter arrangement. For maximum flexibility, the Will (or other document) could leave the interest outright to the participant spouse, but provide for a contingent credit shelter disposition if the participant spouse disclaims the outright legacy.

Where state law permits the aggregate division of community property, consideration should be given to allowing the participant to receive 100% of the IRAs, with other assets of equal value to go to the estate of the non-participant spouse.

G. Conclusion

Community property laws add extra complications to the already challenging task of estate planning with qualified plans and IRAs. To minimize these problems, it is generally desirable for each spouse to leave his or her interest outright to the other spouse. With respect to the participant spouse such a result is consistent with the usual recommendation anyway. With respect to the nonparticipant spouse, the *Boggs* case compels that result as to qualified plans, but as to IRAs special testamentary provisions may be

needed. When the qualified plan or IRA is needed to use up the unified credit of one of the spouses special care has to be taken in the design of the dispositive documents. A restructuring of community property to allow the participant spouse to be the 100% owner of qualified plans and IRAs, while the non-participant spouse becomes the 100% owner of other assets, may be helpful.