McGeorge Law Review

Volume 22 | Issue 3 Article 5

1-1-1991

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Two statutory changes made in 1986, one by an amendment to section 2039 of the Internal Revenue Code[1] which repealed the federal estate tax exclusion for a predeceased nonemployee spouse's community property interest in the surviving spouse's retirement plan benefits, and the other by uncodified legislation which accompanied the enactment of new California Civil Code section 4800.8[2] and abolished the "terminable interest rule," have significantly affected the federal estate tax treatment of a nonemployee spouse's California community property interest in the surviving employee spouse's qualified retirement plan benefits.[3] Both changes were given little attention at the time they were made and their interrelationship apparently was not considered by either Congress or the California Legislature. These changes have a significant impact on estate planning for married

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1. I.R.C. § 2039 (West 1989) (hereinafter "I.R.C.").
2. 1986 Cal. Stat. ch. 686.
3. The terms "qualified retirement plan" and "qualified plan" refer to plans established by private employers offering employees of the employer retirement and death benefits on terms which meet the requirements of I.R.C. section 401. It does not include plans under which retirement and death benefits are offered to federal employees or employees of a state or other governmental unit, old age and survivors benefits offered under federal or state law or nonqualified deferred compensation plans. Qualified plans are subject not only to the requirements of the Internal Revenue Code but also to the rules and requirements of the Employee Retirement Income Security Act of 1974, as amended, 29 U.S.C. section 1001 *et. seq.* (hereinafter "ERISA"). Citations to ERISA are to the sections of ERISA, not the United States Code.

couples in situations where one of the spouses has earned substantial retirement benefits and the total estate is of a size which makes the federal estate tax a factor in the planning process.

I. Federal Estate Tax Law

The change in section 2039 was made by the Tax Reform Act of 1986,[4] which included, in the Technical Corrections portion of that law, a repeal of section 2039(c).[5] Until it was repealed in 1986, section 2039(c) excluded the decedent's community property interest in the surviving spouse's qualified retirement plan benefits attributable to contributions made by the surviving spouse's employer from the gross estate of a nonemployee spouse who predeceased the employee spouse.[6]

Section 2039(c) was originally added to section 2039 as subsection (d) in 1972.[7] At that time, section 2039(c) contained a general exclusion from the employee spouse's gross estate for the decedent's interest in qualified plan benefits attributable to contributions made by the decedent's employer. When it enacted the exclusion for a nonemployee spouse's community property interest in the surviving spouse's plan benefits, Congress expressed concern that the absence of such an exclusion was producing discrimination against married couples in community property

4. Pub. L. No. 99-514, 100 Stat. 2085 (1986) (hereinafter "TRA 1986").

5. TRA 1986, *supra* note 4, § 1852(e)(1)(A).

6. The estate tax exclusion did not extend to the community property interest of the deceased nonemployee spouse in benefits attributable to contributions made by the surviving employee spouse. Because the surviving employee spouse's right to these benefits is always "vested" (i.e. nonforfeitable), the inclusion of the predeceased nonemployee spouse's community property interest in those benefits in the gross estate of the nonemployee spouse for federal estate tax purposes did not and does not pose the difficult questions of valuation as discussed *infra*, text at notes 36-39. Benefits attributable to contributions made by the employee spouse are, however, subject to the terms of the plan which regulate the payment of benefits and to the required restraint on alienation discussed *infra*, text at note 32. Therefore, the inclusion of this portion of the plan benefits in the nonemployee spouse's gross estate can still create difficult valuation questions and serious liquidity problems. TRA 1986 section 1852(e)(2)(A) also repealed the parallel gift tax exclusion in I.R.C. section 2517(c).

7. Pub. L. No. 92-580, 86 Stat. 1276 (1972).

states.[8]

In 1982, Congress limited the section 2039(c) exclusion from the employee's gross estate for qualified plan benefits to $100,000;[9] then in 1984, Congress eliminated that exclusion entirely.[10] In the 1984 Act, however, Congress retained the exclusion originally contained in section 2039(d) for the nonemployee spouse's community property interest in the employee

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8. The Senate Report states:

> The amendment [to H.R. 1467] removes a discrimination in existing estate tax law against spouses of employees in community property States who die before the employee spouse . . . . In a common law State where the nonemployee (often the wife) dies first, no value representing the employer's contribution is included in her estate tax base. However, in a community property State, as a result of the operation of the community property laws, half of the value of the annuity [sic] in such a case is included in the estate tax base of the nonemployee spouse, even though attributable to employer contributions. This amendment overcomes this discrimination against nonemployee spouses in community property States.

S. Rep. No. 92-1290, 92d Cong., 2d Sess. 1 (1972). *See also* Conf. Rep. No. 92-1306, 92d Cong., 2d Sess. 2 (1972) (providing a similar explanation). No mention is made in either report of the valuation and liquidity problems created by the inclusion of the nonemployee's community property interest in the employee spouse's plan benefits. *See infra* text at notes 36-39. The reference in the reports to "the annuity," although the reference is clearly to plan benefits of all types, is typical of what appears to be a lack of understanding as to the nature of qualified plan benefits on the part of those responsible for the drafting of estate and gift tax provisions dealing with qualified plan benefits. This seems apparent in the 1988 changes in I.R.C. section 2056(b)(7) discussed *infra*, text at notes 52-54.

9. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Title II, § 245(a), 96 Stat. 524 (1982) (commonly referred to as "TEFRA") (adding I.R.C. section 2039(g) containing the $100,000 limitation).

10. Tax Reform Act of 1984, Pub. L. No. 98-369, 98th Cong., 2d Sess., Div. A, Title V, § 525(a), 98 Stat. 873 (1984). The General Explanation of the act prepared by the staff of the Joint Committee on Taxation states:

> The Congress recognized that the $100,000 limit on the estate tax exclusion imposed by TEFRA created complex allocation problems for purposes of calculating the amount of retirement benefits that were excludable from the gross estate. In addition, the Congress believed that a separate estate tax exclusion for retirement benefits provided under qualified plans, etc., was unnecessary because these benefits generally are eligible for the unlimited marital deduction and the unified credit against estate tax. Finally, the Congress believed it was appropriate to repeal the separate estate tax exclusion for retirement benefits.

General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 824 (1984).

spouse's qualified plan benefits, reenacting that exclusion in a somewhat modified form as section 2039(c).[11] Finally, in 1986, Congress repealed the exclusion, then contained in section 2039(c),[12] apparently in the belief that the potential for discrimination which led to the original enactment of the exclusion had been eliminated by the repeal of the employee spouse's exclusion in 1984.[13]

As a result, an exclusion is no longer available with respect to a nonemployee spouse's community property interest in the surviving employee spouse's plan benefits. That interest will be included in the nonemployee spouse's gross estate to the extent required by other provisions of the federal estate tax law in situations where the nonemployee spouse predeceases the employee spouse. The inclusion in most cases will be under section 2033,[14] based on the decedent's interest under state community property law in the surviving spouse's plan benefits, not under section

11. Tax Reform Act of 1984, *supra* note 10.

12. TRA 1986, *supra* note 4, § 1852(e).

13. The repeal of section 2039(c) was in the Technical Corrections portion of the Act. The General Explanation prepared by the Joint Committee on Taxation states: "Under the Act, the special community property rules applicable to qualified plans . . . for purposes of the estate and gift tax are repealed. However, the Act clarifies that, if a transfer is made *to an employee spouse* by a nonemployee spouse in a community property state, the amount transferred is eligible for the unlimited marital deduction . . . ." Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation, 140 (1987) (emphasis added). The House and Senate Reports contain similar language. H. Rep. No. 99-426, 99th Cong., 1st Sess. 994 (1985); S. Rep. No. 99-313, 99th Cong., 2d Sess. 1019 (1986). There is no explanation anywhere as to where the clarification as to the marital deduction is to be found, and the act contained no modification of I.R.C. section 2056. The repeal of section 2039(c) actually recreated one aspect of the discrimination against residents of community property states which Congress sought to eliminate by the addition of the exclusion for the interest of a predeceased nonemployee spouse in section 2039(d) in 1972. *See supra* note 8. If the nonemployee spouse predeceases the employee spouse in a separate property state, no interest in the surviving spouse's qualified plan benefits would exist to be included in the decedent's gross estate. By the death of the surviving employee spouse, the plan benefits may well have been exhausted, so that no portion of those benefits is ever subjected to transfer tax. In a community property state, however, where the state recognizes the nonemployee spouse's community property interest in the surviving employee spouse's plan benefits as one which survives the prior death of the nonemployee spouse so that interest may be passed to that spouse's successors, the deceased nonemployee spouse's interest will be included and subjected to tax in the decedent's gross estate, regardless of whether any interest in the benefits survives the death of the surviving employee spouse. *See infra* note 78.

14. I.R.C. § 2033 (West 1990).

2039[15] which deals with annuities. The amount includable, if any, will therefore be determined by the state community property law which defines the extent of the decedent's community property interest subject to taxation. In California, this reference to state community property law leads into an area of great difficulty and uncertainty and raises serious questions as to what, in any, interest in the surviving spouse's qualified plan benefits will now by includable in the nonemployee spouse's gross estate.

II. California Community Property Law

For many years, the community property law of the state of California has been very much in doubt with respect to the rights and interests of the spouses in retirement plan benefits earned during their marriage by one of the spouses. Early cases held that the nonemployee spouse had no community property interest in the employee spouse's retirement plan benefits, at least in situations where those benefits were not "vested," because it was said that the employee spouse's rights were nothing more than a "mere expectancy" to which no community property incidents could attach.[16]

In 1976, in *Marriage of Brown,*[17] the California Supreme Court overruled these cases and held that the nonemployee spouse does have a community property interest in the employee spouse's retirement plan benefits, even in situations where those benefits are "nonvested."[18] Although this resolved the question of whether the nonemployee spouse had a community property interest in the

15. *Id.* § 2039.

16. *See* French v. French, 17 Cal. 2d 775, 778, 112 P.2d 235, 236-37 (1941) (nonemployee's interest is a "mere expectancy," not a community property interest). *See also* Reppy, *Community and Separate Interests in Pensions and Social Security Benefits after* Marriage of Brown *and ERISA*, 25 UCLA L. Rev. 419 (1978) (discussing the *French* case in detail).

17. *In re* Marriage of Brown, 15 Cal. 3d 838, 544 P.2d 561, 126 Cal. Rptr. 633 (1976). *See also* Reppy, *supra* note 16, at 421-43 (analyzing *Marriage of Brown*).

18. *In re* Marriage of Brown, 15 Cal. 3d at 844-45, 544 P.2d at 564-65, 126 Cal. Rptr. at 636-37. The use made of the terms "vested" and "nonvested" by the California courts is not consistent with the use of those terms under ERISA and the parallel provisions of the Internal Revenue Code dealing with qualified plans. *See* Reppy, *supra* note 16, at 421-443.

employee spouse's plan benefits, it left very much in doubt the extent and nature of that interest.

In a series of cases decided before *Marriage of Brown* involving benefits under retirement plans established for state and other public employees, the California courts developed a rather strange and ill-defined doctrine commonly known as the "terminable interest rule."[19] In effect, the courts said whatever the interest of the nonemployee spouse in the employee spouse's plan benefits while both spouses are still alive, that interest terminates at the death of the first spouse. As a result, if the employee spouse died first, the surviving spouse's interest in the benefits earned by the decedent prior to death terminated, and any death benefits payable under the plan would all pass in accordance with the terms of the plan or the employee spouse's beneficiary designation, if such a designation was permitted by the plan.[20] Because the nonemployee spouse's interest in the deceased employee's plan benefits terminated at the death of the employee spouse, the surviving nonemployee spouse was denied any control over the disposition of those benefits.

If the nonemployee spouse was the first to die, the courts said the decedent's community property interest in the surviving spouse's retirement plan benefits simply terminated at the death of the nonemployee spouse and, therefore, was not subject to the decedent's power of testamentary disposition.[21] This left the surviving employee spouse as the sole owner of the benefits to use or dispose of them as he or she might choose.

Because the "terminable interest rule" was developed in cases dealing with benefits granted to state and other public employees and was rationalized as necessary to enable public bodies to

19. The rule has also been referred to as the "*Benson-Waite* doctrine." *See* Reppy, *supra* note 16, at 443. The most recent discussion of the development and applications of the "terminable interest rule" in the marital dissolution context is in Culhane, *Toward Pension Equality: A Reexamination of California's Terminable Interest Doctrine*, SW. U. L. REV. 613 (1984). *See generally* Reppy, *supra* note 16, at 443-82 (providing a detailed analysis of early cases).

20. *See* Benson v. Los Angeles, 60 Cal. 2d 355, 363, 384 P.2d 649, 653-54, 33 Cal. Rptr. 257, 261-62 (1963). Upon the prior death of the employee spouse, the employee spouse's benefits will be distributed as provided in the plan and any employee beneficiary designation. *Id.*

21. *See* Waite v. Waite, 6 Cal. 3d 461, 474, 492 P.2d 13, 21, 99 Cal. Rptr. 325, 333 (1972).

effectively deal with retirement and death benefits for their employees,[22] the extent to which it was applicable to private retirement plans benefits was very much in doubt. Some cases, however, have applied the doctrine to private plan benefits as well as those under plans established for public employees.[23]

The development and uncertainties of the "terminable interest rule" have been well documented and analyzed in a series of critical discussions of the doctrine.[24] Most commentators,[25] focusing on the application of the doctrine in marital dissolution situations, have expressed the view (perhaps more accurately described as the hope) that the decision of the California Supreme Court in *Marriage of Brown*, overruling the earlier cases and recognizing the nonemployee spouse's community property interest in the employee spouse's retirement plan benefits, was inconsistent with continued recognition of the "terminable interest rule," at least in the marital dissolution setting. Some California courts accepted this analysis[26] while others continued to apply the

22. *See* Reppy, *supra* note 16, at 446-56 (reviewing in detail the justifications and rationalizations advanced for the "terminable interest rule").

23. *See, e.g., In re* Marriage of Bruegl, 47 Cal. App. 3d 201, 206, 120 Cal. Rptr. 597, 600 (1975) (terminable interest doctrine applies to private plan benefits).

24. *See* Reppy, *supra* note 16; Culhane, *supra* note 19. *See also* Comment, *The Community Property Status of the Pension and the Widow's Death Benefits*, 37 S. CAL. L. REV. 594 (1964); Comment, *Retirement Pay! A Divorce in Time Saved Mine*, 24 HAST. L. J. 347 (1973); Theide, *The Community Property Interest of the Non-Employee Spouse in Private Employee Retirement Benefits*, 9 U.S.F. L. REV. 635 (1975); Solomon, *Beyond Preemption: Accommodation of the Nonemployee Spouse's Interest under ERISA*, 31 HAST. L. REV. 1021 (1980). All of these discussions focus primarily or exclusively on the application of the doctrine in marital dissolution situations and antedate enactment of the Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1445 (hereinafter "REA 1984") which added provisions on "qualified domestic relations orders" to ERISA and the parallel provisions of the Code. *See infra* note 29.

25. *See, e.g.,* Reppy, *supra* note 16, at 421-43. *See generally* Culhane, *supra* note 19.

26. *In re* Marriage of Allison, 189 Cal. App. 3d 849, 854-55, 234 Cal. Rptr. 671, 674 (1987); Bowman v. Bowman, 171 Cal. App. 3d 148, 155-57, 217 Cal. Rptr. 174, 178-79 (1985); Chirmside v. Board of Admin. of Pub. Employees Retirement Sys., 143 Cal. App. 3d 205, 210-11, 191 Cal. Rptr. 605, 608 (1983). In one case, a federal district court, applying California law, ordered a division of the death benefit payable under a private union pension plan between a former wife, who never finalized the dissolution action which she initiated before her husband's death and never obtained an award of an interest in her husband's pension, and a subsequent "putative spouse." Western Conference of Teamsters Pension Trust Fund v. Jones, 646 F. Supp. 228, 231-32 (N.D.Cal. 1986). The district court, after considering an argument by the plan that the former wife's interest in the deceased employee's benefits terminated at his death under the "terminable interest rule," said: "[R]ecent decisions of the California Supreme Court indicate that the 'terminable interest doctrine'

doctrine, both in the marital dissolution setting[27] and, in at least one case, to prevent the imposition of a California state inheritance tax on the nonemployee wife's interest in her surviving husband's retirement plan benefits.[28]

In 1986, the California Legislature attempted to deal with the problems created by the "terminable interest rule" in marital dissolution cases by adding section 4800.8 to the Civil Code.[29] That section makes it clear that a California court in a dissolution action must take account of the retirement plan benefits earned by either spouse during the marriage in making or approving a property settlement between the spouses, and gives the court power to make specific orders to effectuate the settlement with respect to the plan benefits, including power to order the division of the benefits and to direct selection of the benefit payment option by the employee spouse. So long as these powers are exercised in a manner consistent with the provisions of federal law in the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which deal with "qualified domestic relations orders," they are permitted without any preemption problem under federal law.[30]

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has passed into legal extinction." *Id.* at 233. The district court cited the *Chirmside* case, *Marriage of Brown*, and *Henn v. Henn*, 26 Cal. 3d 323, 605 P.2d 10, 161 Cal. Rptr. 502 (1980), a case in which the Supreme Court extended its decision in *Marriage of Brown* to recognize a wife's community property interest in her husband's military pension. *Western Conference*, 646 F. Supp. at 233.

27. *In re* Marriage of Lionberger, 97 Cal. App. 3d 56, 71-72, 158 Cal. Rptr. 535, 544 (1979). *See In re* Marriage of Taylor, 189 Cal. App. 3d 435, 234 Cal. Rptr. 486 (1987) (terminable interest rule correctly applied by trial court; however, 1986 legislation changes this and may be applied retroactively). *See infra*, note 31.

28. Estate of Allen, 108 Cal. App. 3d 614, 620, 166 Cal. Rptr. 653, 656 (1980). In response to an argument that the state could or should not curtail the nonemployee spouse's community property interest in the employee spouse's pension plan benefits recognized as community property by *Marriage of Brown*, the court said that the supreme court's decision in *Waite v. Waite*, did just that, commenting, "It seems perfectly appropriate to the function of pension benefits that they automatically pass to the surviving spouse." *Id.*

29. CAL. CIV. CODE § 4800.8 (West 1990) (enacted by 1986 Cal. Stat., ch. 686, sec. 1, at 506).

30. ERISA section 206(d)(3), added by REA 1984, *supra* note 24, recognizes a "qualified domestic relations order" which meets the requirements of section 206(d)(3)(B) as an exception to the general rule against alienation of a participant's interest in plan benefits mandated by ERISA section 206(d)(1) (which requires a restraint on alienation of benefits in all qualified plans) and permits a state court to divide the employee spouse's benefits between the employee spouse and the

At the same time that it enacted Civil Code section 4800.8, the California Legislature included in the enacting statute, but not in any of the California codes, a provision stating its intention to "abolish" the "terminable interest rule."[31] The way in which the California Legislature dealt with the matter leaves continuing doubts whether the legislature's action was intended only to enable the courts to take account of retirement plan benefits in handling property settlements incident to marital dissolutions, or, more broadly, to recognize the nonemployee spouse's interest in the employee spouse's retirement benefits as a full community interest, including a right of testamentary disposition with respect to that interest in the event of the prior death of the nonemployee spouse while the spouses remain married.

The 1986 legislation dealt only with the division of one spouse's retirement plan benefits in a dissolution action and contained no modification of the California Probate Code, thus suggesting that the legislature had no intention to confer on the nonemployee spouse any testamentary power over the employee spouse's retirement plan benefits not already recognized under California community property law. At least three California courts, however, have interpreted the legislature's abolition of the "terminable interest rule" as conferring on the nonemployee spouse all of the incidents which normally attach to community property, including a right of testamentary disposition as to the decedent's interest.[32]

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nonemployee spouse. ERISA § 206(d)(3). The addition of the provisions dealing with qualified domestic relations orders to ERISA (and the addition of parallel provisions to the Internal Revenue Code, I.R.C. sections 401(a)(13)(B) and 414(p)) has eliminated many of the remedial problems and concerns posed by an attempt by a state court to divide the employee spouse's benefits before 1984, including the preemption questions discussed in Reppy, *supra* note 16, at 527-542.

31. 1986 Cal. Stat., ch. 686, sec. 2, at 506.

32. One California appellate court held that the enactment of 1986 California Statutes chapter 686, section 2, abolishing the "terminable interest rule" after a decision by the trial court against awarding the nonemployee spouse an alienable interest in the employee spouse's retirement plan benefits, was effective to require that the trial court's action be modified. *In re* Marriage of Taylor, 189 Cal. App. 3d 435, 442, 234 Cal. Rptr. 486, 490 (1987). The court remanded the case to the trial court with directions to apply California Civil Code section 4800.8 in a manner which would give the nonemployee spouse a power of testamentary disposition over the interest in her husband's retirement benefits awarded to her. *Id.* at 443, 234 Cal. Rptr. at 491. Another court held that the uncodified language enacted in 1986 Cal. Stat. ch. 686, section 2, retroactively changed the law

If the 1986 California legislation has given the nonemployee spouse a power of testamentary disposition over his or her community property interest in the employee spouse's retirement plan benefits on the prior death of the nonemployee spouse *in the absence of a dissolution of the marriage*, there appears to be a significant question as to whether that action is valid. Federal law includes an express provision in ERISA which requires that every qualified plan contain a restraint on alienation (commonly referred to as a "spendthrift restraint") which prohibits a plan participant from assigning or otherwise alienating the benefits to which the participant is entitled under the plan.[33] ERISA also contains an express preemption provision which clearly states that federal law controls where a conflict with state law exists.[34]

Generally, it seems well established by now that the law on retirement plans in ERISA (and in the parallel provisions of the Internal Revenue Code) does not preempt state community property laws as applied to the benefits created for married employees who

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established in *Waite* and caused the interest of the nonemployee spouse in the employee spouse's retirement plan benefits to include a power of testamentary disposition sufficient to subject that interest to inheritance tax in the estate of the predeceased nonemployee spouse. Estate of Austin, 206 Cal. App. 3d 1249, 1255, 254 Cal. Rptr. 372, 375 (1988). A third court has held that the 1986 legislation can be applied retroactively to enable the court which retained jurisdiction over retirement benefits in a prior dissolution action to award the estate of the nonemployee spouse who predeceased both the employee spouse *and* the enactment of the 1986 legislation an interest in the surviving spouse's retirement benefits upon his retirement following the predeceased wife's death. *In re* Marriage of Powers, 218 Cal. App. 3d 626, 640-42, 267 Cal. Rptr. 350, 357-58 (1990). These cases give the fullest possible effect to the 1986 legislation. *See infra* note 71 for further comment on these cases.

33. ERISA §206(d)(1) (stating a provision parallel to I.R.C. section 401(a)(13)(A) that "[e]ach pension plan shall provide that benefits provided under the plan may not be assigned or alienated."). The exception for a qualified domestic relations order, enacted in 1984, would not apply because the testamentary power is created under state law as an incident of the nonemployee spouse's community property interest, not by a qualified domestic relations order. *See supra* note 30 (discussion of 1984 ERISA provisions). The same conflict between state and federal law would not arise where the nonemployee spouse is awarded an interest in the employee spouse's plan benefits under California Civil Code section 4800.8, even if the award expressly recognized the owner's power of testamentary disposition over the awarded interest, because in this case the exception for qualified domestic relations orders would apply, so long as the award satisfied the requirements of ERISA section 206(d)(3)(B).

34. ERISA section 514(a) states that the provisions of ERISA "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 § 514(a).

are participants in the plans subject to federal regulation.[35] However, the cases decided to date do not deal directly with the question of whether the states can, as a part of their community property laws, confer on the nonemployee spouse a power of alienation over that spouse's community property interest in the surviving spouse's plan benefits exercisable on the prior death of the employee spouse while the parties are still married. Such a power appears inconsistent with the provisions of ERISA which require that every plan impose restraints that prevent the employee spouse who is a participant in the plan from alienating his or her interest in the plan before the benefits are paid or distributed. Recognizing a power of testamentary disposition over the predeceased nonemployee spouse's community property interest in the surviving spouse's retirement plan benefits, in effect, would give the nonemployee spouse a power which even the employee spouse does not, and, under ERISA, cannot have.[36]

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35. *See* Carpenters Pension Trust for Southern California v. Kronschnabel, 632 F.2d 745, 748 (9th Cir. 1980) (explaining the effect of the dismissal by the United States Supreme Court of an appeal taken in a California case, *In re* Marriage of Campa, as establishing that ERISA does not generally preempt the community property laws of the states as they affect benefits in a qualified plan subject to ERISA). To a large extent the *Kronschnabel* case resolved the preemption issues discussed in Reppy, *supra* note 16, at 483-527, in a manner implicitly approved by the subsequent addition to ERISA of the provisions dealing with qualified domestic relations orders in 1984. *See supra*, note 30. The Supreme Court's dismissal of the *Campa* case did not, however, resolve whether the conflict between the recognition of a power of testamentary disposition in the nonemployee spouse (in the absence of an award which qualifies as a qualified domestic relations order) and the provisions in ERISA section 206(d)(1) which require restraints on alienation of plan benefits, may result in preemption of the state law conferring the power of testamentary disposition on the nonemployee spouse which is exercisable on the nonemployee spouse's death before the plan benefits become payable. The case for preemption as to this more limited question has been significantly strengthened by the 1984 modifications of ERISA. *See supra*, note 30. One writer has stated that REA 1984 preempts state law, preventing a state from conferring on a predeceased nonemployee spouse a power of testamentary disposition over the surviving employee spouse's retirement plan benefits. Golden, *Qualified Plans and the Non-Employee Spouse*, 15 COMM. PROP. J. 18 (1988) (discussing a Texas trial court decision in which the court purported to recognize the right of a predeceased nonemployee spouse to dispose of her community property interest in the surviving spouse's retirement plan benefits to her children). Golden says, "[S]ince the passage of REA in 1984 there can be little doubt that federal preemption has taken over in this area." *Id.* at 25.

36. At least one writer has suggested that the unresolved question of whether a predeceased nonemployee spouse can be given a power of testamentary disposition over the decedent's interest in the surviving employee spouse's retirement plan benefits has constitution implications which could draw into question the validity of the state action, or the federal law if preemption is found. *See* Reppy, *supra* note 16, at 526-27. This suggestion was made, however, before the enactment of REA

At a minimum, it seems fair to conclude that the state law is still far from clear in this area. The California Legislature's action in abolishing the "terminable interest rule," even if it is interpreted as conferring on the nonemployee spouse a power of testamentary disposition over the nonemployee spouse's interest in the surviving employee spouse's retirement plan benefits, has not fully resolved the uncertainties as to the extent of the nonemployee spouse's community property interest under California law.

III. ESTATE PLANNING RAMIFICATIONS

Repeal of the exclusion in section 2039(c) has created serious problems for estate planners in California who deal with estates which include significant retirement plan benefits earned by one of the spouses during the marriage. If the nonemployee spouse's community property interest in the surviving employee spouse's retirement plan benefits is included in the gross estate of the nonemployee spouse on the prior death of the nonemployee spouse, that inclusion will raise difficult valuation questions and may also cause serious liquidity problems.[37]

A. Valuation

No clear statutory or administrative guidance or case law appears to exist on how the now includable interest of the nonemployee spouse is to be valued in many situations for federal estate tax purposes. The inclusion of the nonemployee spouse's interest in the employee spouse's retirement plan benefits occurs under section 2033, not section 2039.[38] The nonemployee spouse's interest does not involve an "annuity" on the life of the surviving spouse in any traditional sense, unless the retirement benefits under the plan have commenced and an annuity pay-out has already been

in 1984.

37. The problems in this regard are noted without discussion or resolution in Irish, *Estate and Gift Ramifications of the Employee Benefit Provisions of the Tax Reform Act of 1986*, 21 INST. ON EST. PLAN. ¶1604 (1987).

38. *See supra* text at notes 14 and 15.

selected.

Where an annuity pay-out measured by the life of the surviving employee spouse or a joint and survivor annuity payout over the lives of the two spouses has been selected before the death of the nonemployee spouse, the rules for valuing a survivor annuity would apply and resolve the valuation problem.[39] If the surviving spouse is still actively employed at the death of the nonemployee spouse, however, the surviving spouse's benefits may not become payable until years after the nonemployee spouse's death and may never be paid to the surviving spouse, if he or she dies before retirement.

At retirement, under many plans, benefits may be taken in any one of several ways, including a lump sum and a joint and survivor annuity payable to the surviving spouse and his or her current spouse.[40] Since the form of benefit payments is regulated by the terms of the plan under the rules established by federal law and not by the state's community property laws, those who would inherit the nonemployee spouse's interest in the employee spouse's plan benefits would take only the interest as defined by the terms of the plan and will normally have little or no control over how and when the plan benefits are to be received. In most situations valuation of the nonemployee spouse's interest seems to pose some very difficult, if not insurmountable problems.

B. Liquidity

Even more significant may be the liquidity problems presented to the predeceased nonemployee spouse's estate. Although the decedent's community property interest in the surviving spouse's retirement benefits will be included and taxed in the nonemployee spouse's estate, the estate will normally have no access to funds

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39. *See* Treas. Reg. §20.2039-1 (1976). Treas. Reg. §20.2039-2 governing annuities under qualified plans has not been modified to reflect the repeal of the exclusion for qualified plan benefits formerly in I.R.C. section 2039(c) in 1984, *see infra* text at note 10, or the repeal of the exclusion for the nonemployee spouse's community property interest, *see infra* text at note 12.

40. ERISA section 205 requires that the plan benefits be paid out in the form of a joint and survivor annuity unless a specific statutory exemption applies or unless an election is made by the employee spouse with the consent of the nonemployee spouse to take the benefits in some other payment form. I.R.C. sections 401(a)(11) and 417 contain parallel provisions.

from the plan with which to pay the tax. In addition, as required by federal law, the interest will be subject to a "spendthrift restraint" which will effectively prohibit the estate from encumbering the interest to obtain borrowed funds with which to pay the tax.

C. Use of the Marital Deduction

In most cases, it will be important, if not imperative, that the interest of the nonemployee spouse in the employee spouse's retirement plan benefits be disposed of in a way that will qualify the interest for the marital deduction, to minimize or avoid the problems posed by the inclusion of that interest in the nonemployee spouse's gross estate on that spouse's prior death because of the repeal of section 2039(c). The legislative history of the provisions in the 1986 Act containing the repeal of section 2039(c) indicates that Congress thought that the marital deduction should be available, although Congress made no change in the provisions of section 2056 to liberalize the rules on the marital deduction to facilitate that result.[41]

If, on the prior death of the nonemployee spouse, the nonemployee spouse's interest in the employee spouse's retirement plan benefits is disposed of by the nonemployee spouse by will or intestate succession *to the surviving spouse*, the disposition clearly will qualify for the marital deduction. But, what if the disposition is made to a qualified terminable interest property ("QTIP") trust in which the employee spouse, as the surviving spouse, is given only a life income interest? Availability of the marital deduction with respect to this type of disposition is very doubtful.

Section 2056(b)(7)(B) requires that the surviving spouse be given a "qualifying income interest" in the trust property to qualify that property for the QTIP election.[42] Section 2056(b)(7)(B)(ii) says that "an annuity shall be treated in a manner similar to an income interest in property" under regulations to be

41. *See supra* note 13.
42. I.R.C. § 2056(b)(7)(B) (West 1989).

prescribed.[43] Since no final regulations have been issued under this provision, its effect remains largely unknown.

Where the distribution of plan benefits has started before the death of the nonemployee spouse and an annuity pay-out over the life of the surviving employee spouse or a joint and survivor annuity pay-out over the joint lives of the spouses has been selected, the proposed regulations under section 2056, as amended in 1981, indicate that the annuity may qualify for the marital deduction as qualified terminable interest property.[44] An installment distribution, which requires all of each year's income to be distributed as a part of that year's distribution, will also qualify, even though this distribution form is not an annuity.[45] In many cases, however, the future benefits to which the surviving spouse may ultimately become entitled do not fit the customary and accepted concept of an "annuity," particularly when the surviving spouse is still actively employed at the prior death of the nonemployee spouse and may have several benefits options available at or after actual retirement.

The proposed regulations under section 2056 as modified in 1981 deal primarily with traditional annuities and are of little help with respect to a nonemployee spouse's community property interest in the surviving spouse's retirement plan benefits unless an annuity pay-out has already been selected.[46] These regulations do clearly state, however, that the marital deduction is *not available* with respect to an annuity which permits the surviving spouse to receive "any distribution of the property or its income . . . out of which the annuity is payable."[47] In situations where an annuity payout has not already been selected, it seems very doubtful that the surviving spouse's interest as the income beneficiary of the QTIP trust established by the nonemployee spouse in the nonemployee spouse's interest in the surviving spouse's own retirement benefits placed in that trust would qualify as an

43. *Id.* § 2056(b)(7)(B)(ii).
44. Prop. Treas. Reg. §20.2056(b)-7(c)(2) (1984).
45. *Id.* § 20.2056(b)-7(e), ex. 10.
46. *See id.* § 20.2056(b)-7(c)(2).
47. *Id.*

"annuity" passing to the QTIP trust on which the marital deduction could be taken.[48]

The income requirement is the biggest problem faced in claiming the marital deduction with respect to the nonemployee spouse's interest in the surviving spouse's retirement plan benefits in a disposition to a QTIP trust. Section 2056(b)(7)(B)(ii)(I) requires that the surviving spouse be given "*all* of the income" from the trust property "annually or at more frequent intervals."[49] The legislative history of the qualified terminable interest property provisions in section 2056(b)(7) indicates that the surviving spouse's interest as the income beneficiary of a QTIP trust will not be sufficient to qualify the nonemployee spouse's interest in the surviving spouse's plan benefits which pass to the QTIP trust for the marital deduction because it is not certain that the surviving spouse will receive all or even any of the income produced by that interest.[50] This seems particularly true where the plan is a defined benefit plan under which the benefits to be received by the surviving spouse on actual retirement are not dependent upon or even related to the income produced by the trust property.

The proposed regulations under section 2056 as modified in 1981 clearly indicate that the surviving spouse's income rights in a QTIP trust must create an actual right to real income, by referring to the regulations now in force under section 2056(b)(5).[51] Those

48. *See* Hoffman & Brucker, *Estate Planning for Qualified and Non-Qualified Plans*, 1989 So. CALIF. TAX INST. 17-12 to 17-14 (hereinafter "Hoffman & Brucker"), for a discussion of whether the plan, itself, and its accompanying trust can be treated as a QTIP or other trust which will permit the plan interest to qualify for the marital deduction.

49. I.R.C. § 2056(b)(7)(B)(ii)(I) (West 1989) (emphasis added).

50. The General Explanation of the 1981 Act provisions on the unlimited marital deduction contains the following statement: "A qualifying income interest for life in any property *must* provide the spouse with a degree of beneficial enjoyment sufficient to satisfy the rules applicable to marital deduction trusts under Treas. Reg. § 20.2056(b)-5(f)." General Explanation of the Economic Recovery Act of 1981, 235 (1981) (emphasis added).

51. Proposed Treasury Regulations section 20.2056(b)-7(c)(1) states:

> In general, the principles outlined in § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest, are applicable in determining whether the surviving spouse is entitled for life to all of the income from the property, regardless of whether the interest passing to the spouse is in trust.

regulations state that the surviving spouse must actually be able to receive income produced by the property for which the marital deduction is claimed.[52]

In the situation where the death of the nonemployee spouse occurs when the employee spouse is still actively employed, and no election has been made as to the form of benefit payments, no assurance exists that the surviving employee spouse will actually receive any of the income from the nonemployee spouse's interest in his or her own retirement benefits which passed to the QTIP trust. For example, the surviving spouse could die while still actively employed and before receiving any of the benefits afforded under the retirement plan so that the full amount of the benefit, including income earned after the nonemployee spouse's death, would pass to the employee spouse's designated beneficiary or to those specified in the plan to receive the death benefits. At the present time it would be very unwise to assume that a disposition by the predeceased spouse of his or her community property interest in the surviving employee spouse's retirement benefits to a QTIP trust will qualify that interest for the marital deduction.

In 1988, Congress added to the uncertainty by adding section 2056(b)(7)(C), which treats the interest of a surviving spouse in an annuity as a qualifying income interest under section 2056(b) if the surviving spouse is to receive all of the annuity payments before the death of the surviving spouse, unless an election to the contrary is made by the executor of the deceased spouse's estate.[53] Section 2523(f)(6)(D), added at the same time, provides that "no amount shall be includable *in the gross estate of the [nonemployee] spouse under § 2044* with respect to" a joint and survivor annuity in which the decedent and the surviving spouse have a right to receive all payments prior to the death of the surviving spouse.[54] These

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Prop. Treas. Reg. § 20.2056(b)-7(c)(1) (1984).

52. Treas. Reg. § 20.2056-5(b) - 5(f) (1985).

53. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 100th Cong. 2d Sess, §6152, 102 Stat. 3725 (1988) (adding I.R.C. §2056(b)(7)(C)).

54. I.R.C. § 2523(f)(6)(D) (West 1989) The 1988 changes and the odd placement of the estate tax exclusion in the gift tax provisions of the Code are discussed in Hoffman & Brucker, *supra* note 47 at 17-7 to 17-14.

provisions would be of no help unless the payment of plan benefits has commenced under an irrevocable election as to the payment method, or, apparently, in situations where the plan benefits are being or will be paid out in installments as opposed to an annuity pay-out.[55]

D. *Foregoing the Marital Deduction--A "Double Tax?"*

If a decision is reached to forego the marital deduction and face the valuation and liquidity problems by allowing the nonemployee spouse's interest in the employee spouse's retirement plan benefits to be taxed in the nonemployee spouse's estate, no assurance exists that this decision will produce an exclusion from the employee spouse's gross estate for any plan benefits taxed in the predeceased spouse's estate which have not been consumed when the employee spouse later dies. For example, if the nonemployee spouse, prior to death, exercises a power of testamentary disposition conferred by state law over his or her community property interest in the surviving spouse's retirement plan benefits to pass the nonemployee spouse's interest to the child or children of the spouses, not only will that interest be taxed in the nonemployee spouse's estate, but it at least appears possible that the full value of any benefits remaining at the surviving spouse's death also will be taxed in the estate of the surviving employee spouse. Under the terms of most qualified retirement plans, the participant is given the right to designate the recipient of the death benefit. Under ERISA, that designation apparently may be made after the prior death of the nonemployee spouse, without participation by those who took the nonemployee spouse's community property interest in those benefits at the prior death of the nonemployee spouse.[56] It is yet undecided to what extent state

55. *See* Hoffman & Brucker, *supra* note 47 at 17-12.

56. The joint and survivor annuity and the preretirement survivor annuity requirements imposed by section 205(a) of ERISA would not apply if the participant were not married on the date when the benefits become payable. Under the terms of most plans a participant who is not married can unilaterally select the designated beneficiary. This may be a matter in which a state court could act to protect the interests of those who took the interest of the predeceased spouse by inheritance

law may limit the surviving employee spouse's exercise of these rights created under federal law, by conferring powers over the inherited interest on those to whom the nonemployee spouse's interest passed at the nonemployee spouse's death. The employee spouse's designated beneficiary could conceivably be the estate of the decedent, so it would appear that the surviving employee spouse may hold a general power of appointment over the predeceased spouse's interest in the retirement plan benefits at death, unless the application of state law prevents that characterization.[57]

Can the surviving employee spouse's power be exercised to cut off the interest of those who took the predeceased spouse's interest in the decedent's plan benefits? Unfortunately, this question has no certain answer, although an affirmative conclusion seems unlikely. However, the question is one that again raises issues of preemption which have not yet have been clearly resolved. And so, arguably, the decedent could be found to have died holding a general power of appointment over the entire death benefit, thus causing it to be includable in the surviving spouse's estate under I.R.C. section 2041, even though an interest in those benefits was previously taxed in the predeceased spouse's estate.

E. Retirements Benefits Planning Under Existing Law

In view of all of this uncertainty under both the federal estate tax law and the community property law of California, the only reasonable course for the estate planner would seem to be to make specific provision for the nonemployee spouse's interest in the employee spouse's retirement plan benefits in a manner that assures the availability of the marital deduction for that interest if the nonemployee spouse dies first. This apparently requires an outright disposition of the interest to the surviving employee spouse unless

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through imposition of a constructive trust. *See* Brazil v. Silva, 181 Cal. 490, 494-95, 185 P. 174, 176 (1919). This action would, however, suggest further preemption questions.

57. A "general power of appointment" is defined for Federal estate tax purposes as "a power exercisable in favor of the decedent, *his estate*, his creditors, or *the creditors of his estate* . . . ." I.R.C. § 2041(b)(1) (West 1989) (emphasis added).

an irrevocable election to take the plan benefits in the form of an annuity on the life of the employee spouse or a joint and survivor annuity on the lives of both spouses is acceptable to the spouses and has already been made at the death of the predeceased nonemployee spouse.[58] These steps will at least enable the estate of the nonemployee spouse to obtain a marital deduction for the interest and should eliminate concerns over the effects of the inclusion of the decedent's interest in the gross estate and the valuation and liquidity problems produced by that inclusion.

Unfortunately, use of an annuity pay-out or disposition of the nonemployee spouse's interest outright to the surviving employee spouse may not be what the nonemployee spouse has in mind for this particular component of the total estate, particularly if the retirement plan represents the major asset of the community. If the nonemployee spouse's interest in the surviving spouse's retirement plan benefits is left outright to the surviving spouse, those benefits will be fully taxed in the surviving spouse's estate and there may be significantly more total tax in the two estates, at least, where the benefits have not been used up or disposed of prior to the surviving spouse's death.[59] However, any other disposition of the nonemployee spouse's interest will produce not only a significant potential tax burden in the estate of the first decedent, but the unattractive possibility that other assets in the estate will be depleted or exhausted through fees, costs, and expenses in attempting to resolve at least some of the uncertainties that any other disposition would raise.

58. *See supra* text at notes 40-55.

59. If the community property interest of the nonemployee spouse in the retirement plan benefits earned by the surviving employee spouse is given outright to the surviving spouse on the prior death of the nonemployee spouse, thus enabling the nonemployee spouse's estate to claim the marital deduction on the full amount included in the nonemployee spouse's estate, it may turn out that the plan benefits are never actually subjected to federal estate tax, because they are used up before the death of the surviving spouse. For example, the surviving spouse could select a single life annuity on his or her life when the surviving spouse actually retires. At the subsequent death of the surviving spouse, there would be nothing left of the plan benefits to transfer or tax in the surviving spouse's estate.

IV. THE NEED FOR FURTHER CLARIFICATION OF CALIFORNIA LAW

Although the changes made in Internal Revenue Code section 2039 and in the community property law of California in 1986 appear separately to be relatively simple modifications of the law, they combine to create an almost impossible tangle of unsettled state and federal law making effective estate planning for a nonemployee spouse's community property interest in significant retirement plan benefits earned by the surviving spouse very difficult. Clearly, neither Congress or the California Legislature intended this result. Each apparently thought it had dealt with a relatively simple matter in a way that would produce clarity and fairness. Instead, we have been given more complexity and uncertainty and significant possibilities for unfairness.

What produces most of the difficulty is not the federal estate tax law as modified in 1986, but the change in the California community property law made in the same year. Although abolition of the "terminable interest rule" was sorely needed in the marital dissolution setting to eliminate unfairness and inequality between spouses, a broader interpretation of the abolition to give a predeceased nonemployee spouse a power of testamentary disposition over his or her community property interest in the surviving employee spouse's retirement plan benefits *in situations where the marriage continues* creates more problems under ERISA and the federal estate tax law than it solves. It is not at all clear that the state is free under ERISA to confer this power on a predeceased nonemployee spouse.[60] Even if it is, the exercise of this power in favor of any beneficiary other than the surviving employee spouse raises almost unsolvable problems under both ERISA and the federal estate tax law.

One is left with the uncomfortable feeling that, for federal estate tax purposes, we might be better off with a "terminable interest rule" of limited application which causes the community property interest of the nonemployee spouse in the employee

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60. *See supra* text at notes 32-35.

spouse's retirement plan benefits to terminate at the death of the first spouse in situations where the parties remain married until that death occurs.[61] If the employee spouse dies first, federal law now protects the surviving spouse, by requiring the consent of the surviving spouse to any settlement or disposition of death benefits to a beneficiary other than the surviving spouse.[62] The surviving nonemployee spouse does not need the protection of a continuing community property interest in the benefits earned by the predeceased employee spouse upon the prior death of the employee spouse because federal law now provides that protection.

If the death benefits are given on the prior death of the employee spouse to a beneficiary other than the nonemployee spouse under a beneficiary designation to which the surviving nonemployee spouse consents, recognition of a community property interest in the benefits in the surviving spouse which does not terminate on the death of the predeceased employee spouse will not alter the disposition. The transfer of the surviving nonemployee spouse's community property interest in the benefits to the beneficiary under the beneficiary designation will instead be treated as a gift by the surviving spouse for federal gift tax purposes,

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61. If a dissolution of the marriage occurs before the death of the first spouse, the division of the retirement plan benefits made pursuant to California Civil Code section 4800.8 could and normally would give the nonemployee spouse a power of testamentary disposition over the interest in the employee spouse's retirement plan benefits awarded to the nonemployee spouse. To the extent that the "terminable interest rule" prevented that under the pre-1986 California law, the abolition of the rule by 1986 Cal. Stat. ch. 686, section 2, changes that result and facilitates the use of section 4800.8 in a manner that makes the division an effective and meaningful one. *See In re* Marriage of Taylor, 189 Cal. App. 3d 435, 440-43, 234 Cal. Rptr. 486, 489-91 (1987). There would appear to be no preemption problem in this state action. *See supra* note 33.

62. This is the effect of the very complex rules on joint and survivor and preretirement survivor annuities added to ERISA section 205 by REA 1984. Parallel provisions were added at the same time to the Internal Revenue Code provisions on qualified plans in I.R.C. sections 401(a)(11) and 417. *See* Treas. Reg. § 1.417(e)-1(b) (1988). *See also* Llewellyn, *Tax-Favored Compensation Plans--Tax Planning for Business Owners and Executives After the Tax Reform Act of 1986 and TAMRA*, 42 TAX LAW. 435, 504-09 (1989). The ERISA provisions on joint and survivor and preretirement survivor annuities and the parallel provisions in the Internal Revenue Code contain exceptions, as, for example, where the spouses have not been married for a full year at the death of the employee spouse. *See* ERISA §205(f)(1); I.R.C. §417(d). The very fact that the federal law recognizes exceptions to the protection afforded a surviving nonemployee spouse would seem to indicate that a state law effectively eliminating the exceptions and imposing a more restrictive rule on the plan participant would be preempted by the federal law.

unless the surviving nonemployee can somehow retain enough control over the property transferred to prevent the gift from being a completed one.[63]

Of course, terminating the surviving nonemployee spouse's interest in the benefits earned by the employee spouse on the prior death of the employee spouse would cause the full value of those benefits to be included in the employee spouse's gross estate for federal estate tax purposes. But, the death benefit can, and usually will, be made payable to the surviving nonemployee spouse on terms which will qualify the benefit for the marital deduction,[64] and if this is done, the inclusion will produce no tax. This creates a strong incentive to make a disposition to the surviving spouse which is consistent with the rules and policy considerations of ERISA. A disposition of the death benefit to someone other than the surviving spouse or a trust which does not satisfy the QTIP trust requirements, either of which would require the consent of the nonemployee spouse, would cause the death benefit to be taxed in full in the employee spouse's estate. But these are the kinds of choices that estate planners regularly deal with.

If the nonemployee spouse dies first, a "terminable interest rule" would prevent inclusion of any interest in the surviving spouse's retirement plan benefits in the decedent's gross estate.[65] As noted earlier, this treatment would cause the full value of the plan benefits to be included and taxed in the estate of the employee spouse on his or her subsequent death, but only to the extent those

63. *See* Treas. Reg. § 25.2511-1(h)(9) (1986). The gift tax exclusion in I.R.C. section 2517(c) which paralleled the estate tax exclusion in I.R.C. section 2039(c) was also repealed in 1986. TRA 1986 § 1852(e)(2)(A). If the surviving nonemployee spouse's interest in the decedent's retirement plan benefits terminates on the prior death of the employee spouse, on the other hand, the consent of the nonemployee spouse to the disposition in favor of the third party beneficiary should not constitute a gift by the surviving nonemployee spouse.

64. This may be more easily said than done, unless the benefits are made payable outright to the surviving spouse. If, instead, the benefits are made payable to a QTIP trust, the distribution rules in I.R.C. section 401(a)(9) must be dealt with, along with the requirements of I.R.C. section 2056(b)(7).

65. If the predeceased nonemployee spouse's community property interest in the surviving employee spouse's plan benefits terminates on the death of the nonemployee spouse, there would be no transfer on the death of the nonemployee spouse to tax under the federal estate tax law, as there is no transfer to tax where the decedent has only a life estate or interest. *See* Helvering v. Safe Deposit and Trust Co. of Baltimore, 316 U.S. 56 (1942).

benefits were not depleted or exhausted prior to the survivor's death. This will be the most likely result under the present state of the law, because those aware of the problems will choose to dispose of the nonemployee spouse's interest in the surviving employee spouse's plan benefits outright to the surviving employee spouse. Recognition of a "terminable interest rule" included in the California community property law would reach this result and avoid the trap for the ill advised or unadvised which exists under the present state of the law.

What the California Legislature did, or intended to do, in 1986 when it abolished the "terminable interest rule" is far from clear. No doubt exists that the 1986 legislation eliminated all aspects and applications of the rule in the marital dissolution setting where the rule had produced strange and unfair results. As a result of the 1986 legislation, the California courts clearly are now empowered to award an interest in retirement benefits earned by the employee spouse during the marriage to the nonemployee spouse and to confer on the nonemployee spouse all of the incidents of ownership of that interest which are appropriate, including a power of testamentary disposition which can be exercised in the event of the prior death of the nonemployee spouse after dissolution of the marriage. This interest is clearly permitted and, indeed, encouraged by the ERISA provisions added in 1984 which deal with qualified domestic relations orders.[66]

But, should the 1986 legislation be interpreted as changing the pre-1986 California law in cases where the marriage is not dissolved, but continues until the death of one of the spouses? Before 1986, the cases said that the community property interest of the nonemployee spouse in retirement plan benefits earned during the marriage by the employee spouse terminated at the death of the first spouse.[67] This rule produced two results depending upon which spouse died first: If the employee spouse died first, the rule left the nonemployee spouse unprotected in the event the employee

66. *See supra* text at note 30.

67. Waite v. Waite, 6 Cal. 3d 461, 473, 492 P.2d 13, 21, 99 Cal. Rptr. 325, 333 (1972); Estate of Allen, 108 Cal. App. 3d 614, 619-20, 166 Cal. Rptr. 653, 656 (1980).

spouse exercised his or her right to designate the beneficiary of the plan death benefits in favor of someone other than the surviving spouse. If the nonemployee spouse died first, the rule denied the nonemployee spouse a power of testamentary disposition over his or her community property interest in the surviving employee spouse's retirement plan benefits, thus causing that interest to terminate and leaving the surviving employee spouse as sole owner of his or her own retirement benefits.

The first result was clearly improper and unfair under California community property laws. That problem has been remedied by the changes in ERISA made in 1984.[68] The second result may not have been a bad one, but rather one consistent with the purpose of retirement benefits and the favorable federal law as to those benefits. One court, commenting on this aspect of the "terminable interest rule" said: "The fact is that the [California] Supreme Court has recognized that a pension is not precisely like other forms of community property; because of its unique purpose a non-employee spouse's interest in pension rights is a '*nontestamentary* community property right' surviving only so long as the non-employee spouse . . . . It is a form of community property to which the testamentary proviso of [former California Probate Code] Section 201, therefore, does not apply."[69] It is certainly arguable that this is the result actually required under the present federal law.

Clearly, the California Legislature was trying to deal effectively with the problems created by the "terminable interest rule" in the marital dissolution setting when it enacted Civil Code

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68. *See supra* text at note 65.

69. Estate of Allen, 108 Cal. App. 3d 614, 620, 166 Cal Rptr. 653, 656 (1980). After quoting from the California Supreme Court's opinion in *Waite v. Waite*, the court said:

> The court thus highlighted the unique place of such a pension in community property law; it is property that is meant to be shared by the spouses and only the spouses, and one whose purpose would be defeated by allowing the deceased spouse to bequeath his or her share to third persons.

Id. at 619, 166 Cal. Rptr. at 656. This language sounds remarkably like the philosophy expressed in the legislative history behind REA 1984. *See, e.g.*, S. Rep. No. 98-575, 98th Cong., 2d Sess. 2-3 (1984).

section 4800.8 and abolished that rule in 1986. It seems highly doubtful that the legislature even considered the effects of the "terminable interest rule" on the federal estate tax treatment of qualified retirement plan benefits earned by one of the spouses during the marriage where the marriage continues until the death of one of the spouses.[70] Should the 1986 legislation then be interpreted as eliminating the "terminable interest rule" in this context? It is submitted that it should not.

A strong possibility exists that the state cannot constitutionally confer on a predeceased nonemployee spouse a power of testamentary disposition over that spouse's interest in qualified retirement plan benefits earned by the surviving spouse during the marriage, unless the state action occurs in connection with an award of that interest in a qualified domestic relations order. ERISA requires that every qualified plan impose a restraint on alienation which prevents the participants who own interests in the plan directly from alienating their interest and benefits.[71] Clearly the state could not confer on the employee spouse a power which conflicted with that requirement. It seems that the state must also be prevented from conferring such a power on the predeceased spouse of a participant simply because, under the state's community property laws, that spouse has a community property interest in the employee's benefits.

In view of the substantial doubts over the intent of the California Legislature and the significant preemption issues which would be raised by interpreting the 1986 California legislation broadly to confer on the nonemployee spouse a power of testamentary disposition over that spouse's interest in the employee spouse's retirement plan benefits in situations where the marriage continues until the prior death of the nonemployee spouse, the 1986

70. 1986 Cal. Stat. ch. 686 included only the enactment of California Civil Code section 4800.8, in §1 of the law, and the uncodified language in section 2, which states in its entirety: "It is the intent of the Legislature to abolish the terminable interest rule set forth in Waite v. Waite and Benson v. City of Los Angeles, *in order that retirement benefits shall be divided in accordance with Section 4800.8.*" 1986 Cal. Stat. ch. 686, sec. 2, at 2313. (citations omitted) [Emphasis added.] Section 4800 deals only with the division of community property in dissolution proceedings, not with the devolution of the interests of the spouses in their community property at death.

71. *See supra* text at note 32.

California legislation should be given an interpretation which is consistent with its limited purpose--to permit the California courts to deal effectively and fairly with retirement benefits earned by a spouse during marriage *when that marriage is being dissolved.* This legislation should not be interpreted so broadly as to confer on the nonemployee spouse who predeceases the employee spouse while the parties remain married, a power of testamentary disposition over the decedent's community property interest in those benefits.[72] This narrower interpretation of the 1986 legislation would be appropriate not only based on legislative intent and as a means of avoiding some very difficult problems of conflict with the federal law in ERISA, it would also produce a more reasonable and uniform result for federal estate tax purposes.

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72. The interpretation suggested is not inconsistent with the decision in *In re* Marriage of Taylor, where it was held that the interest awarded to the nonemployee spouse in a marital dissolution included a power of testamentary disposition, since, in that case, the issue was raised in a dissolution setting, where it is clear that the 1986 legislation was intended to enable the court in the dissolution proceeding to confer full ownership rights in the interest awarded to the nonemployee spouse on the nonemployee spouse, including a power of testamentary disposition. *In re* Marriage of Taylor, 189 Cal. App. 3d 435, 441-43, 234 Cal. Rptr. 486, 489-90 (1987). This interpretation is inconsistent with the decision in *Estate of Austin* in which the court approved the imposition of a state inheritance tax on the interest of the nonemployee spouse in the surviving spouse's qualified retirement plan benefits because the 1986 legislation had the effect of conferring a power of testamentary disposition on the nonemployee spouse, *retroactively.* Estate of Austin, 206 Cal. App. 3d 1249, 1255, 254 Cal. Rptr. 372, 375 (1988). The preemption issues raised by this interpretation of the 1986 legislation apparently were not presented to or considered by the court. The decision in *Taylor,* in which the court retroactively applied California Civil Code section 4800.8 in a dissolution action pending on the effective date of that section, has been followed in *In re* Marriage of Powers to produce a surprising decision which raises serious preemption questions. The court in *Powers,* basing its decision on a legislative purpose in enacting California Civil Code section 4800.8 to protect the interests of a long-term nonemployee spouse *who survives the employee spouse,* awarded the estate of the nonemployee spouse who died *more than three years prior to enactment of the section and survived by the employee spouse,* a share of all future retirement benefits payable because of the surviving spouse's retirement, thus allowing the beneficiaries of the predeceased spouse's estate to enjoy a share of the surviving spouse's retirement benefits. *In re* Marriage of Powers, 218 Cal. App. 3d 626, 640-42, 267 Cal. Rptr. 350, 357-58 (1990). The case, like *Taylor,* is not inconsistent with the interpretation of the 1986 legislation suggested in the text, because it arose in a dissolution action initiated before the death of the predeceased spouse, in which the court reserved jurisdiction over retirement plan benefits. It does, however, raise significant preemption issues under REA 1984 which were not considered by, or apparently argued to, the court. *See supra* notes 34-35.

IV. CONCLUSION

Unfortunately, leaving the resolution of doubts as to the scope and effects of the 1986 legislation adopted in California to the courts may delay clarification of the law in this significant area for many years. Most of the cases on the "terminable interest rule," even those addressing the incidents of the nonemployee spouse's interest in the employee spouse's retirement plan benefits, have been marital dissolution cases. The California courts have not frequently had the opportunity to deal with and define the doctrine in the context of the death of one of the spouses. Until the effect of the 1986 legislation is clarified, the application of the federal estate tax to the community property interest of a predeceased spouse in the surviving spouse's qualified retirement plan benefits will remain in doubt. Estate planning with respect to this interest will be hazardous. This matter calls for prompt action, preferably through further legislation.

The California Legislature should be made to understand both the subtleties of the "terminable interest rule" as it has been applied to retirement plan benefits earned by a spouse during marriage on the death of either spouse and the federal estate tax and estate planning ramifications of the rule. The legislature should be made to recognize that the state of California does not need and, quite probably, is not able to give the nonemployee spouse a continuing interest in the retirement plan benefits earned by the employee spouse on the prior death of the employee spouse; the surviving nonemployee spouse is now protected as to those benefits by federal law.[73] The legislature should also be made to understand that it is dealing with retirement benefits, a unique form of property, and that it does not need and, quite possibly, may not be able to give the nonemployee spouse who predeceases the employee spouse while the marriage continues a power of testamentary disposition over the nonemployee spouse's community property interest in the survivor's retirement plan benefits.

Retirement plan benefits are recognized as a unique and very

73. *See supra* text at note 61.

significant form of property under federal law and are given special advantages because they are an important part of the federal government's retirement income policy, which must be encouraged and protected *for the good of both of the spouses.*[74] The federal law, which protects these benefits for both spouses, probably preempts any effort by the state to confer on a predeceased nonemployee spouse a power of testamentary disposition over his or her community property interest in the surviving employee spouse's retirement plan benefits by which the predeceased nonemployee spouse could deprive the survivor of any part of the benefits earned by the survivor.[75] Express statutory recognition of a limited and continuing "terminable interest rule" in California, to terminate the nonemployee spouse's community property interest in the retirement plan benefits earned by the employee spouse on the death of the first spouse while the spouses remain married, would be consistent with existing federal law and the policy considerations behind it, without retreating from the policy considerations underpinning the community property system on which the 1986 legislation was based. Instead, legislative recognition of a limited "terminable interest rule" would significantly contribute to clarifying both the state law on and the application of the federal estate tax law to qualified retirement plan benefits earned by a married employee.[76]

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74. The Senate Report on ERISA states at the very beginning: "The provisions of [ERISA] are addressed to the issue of whether American working men and women shall receive the private pension plan benefits which they have been led to believe would be theirs upon retirement from working lives." S. Rep. No. 93-127, 93d Cong., 1st Sess. 1 (1974). The Senate Report on REA states: "Under the rules of present law, the participant's spouse may be entitled to no survivor benefits under the plan even though the participant had accrued significant vested benefits before death. Therefore, the committee believes that it is appropriate to provide automatic survivor benefits to the spouses of vested participants." S. Rep. No.98-575, 98th Cong., 2d Sess. 12 (1984). *See* Scott, *A National Retirement Income Policy*, 44 TAX NOTES 913 (1989).

75. *See supra* text at notes 32-35.

76. Applying a limited "terminable interest rule" on the death of the nonemployee spouse would also eliminate the discrimination against California residents recreated by the repeal of the exclusion in section 2039(c) in 1986. See *supra* note 13.