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Michael Ramsey

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NOTES

Community Property—Deferred Compensation Plans— Interest of Nonemployee Spouse at Divorce

James E. Herring began participating in two deferred compensation plans during his marriage to defendant. One, a profit sharing plan, was maintained entirely by contributions of Herring's employer, while the other, an annuity plan, was maintained by joint contributions of Herring and his employer. Although both plans were circumscribed by spendthrift provisions to the extent that he had no presently assignable interest, Herring did have the right to name death beneficiaries and to change the beneficiaries without their consent. At the time of Herring's divorce from defendant, Ellen Herring, the plans were fully vested.¹ Subsequent to the divorce decree a receiver was appointed for the community property, but no disposition was made of the plans prior to Herring's death. After the divorce, Herring changed the death beneficiaries under both plans from defendant to a trustee for the benefit of his children. Upon the death of Herring, the trustee brought an action for a declaratory judgment against the defendant-wife and the community receiver, seeking a declaration that no part of the corpus of the plans was community property as of the time of the divorce. *Held*: Under appropriate facts, an employee's vested interest in deferred compensation plans is community property and the employee's spouse is entitled upon divorce to one-half of the value of the plans on the date of divorce. *Herring v. Blakeley*, 385 S.W.2d 843 (Tex. 1965).

In recent years, primarily for tax reasons,² deferred compensation

¹ In regard to vesting the court states:

[T]he profit-sharing account was fully vested in Herring at the time of the divorce. The ownership of this account was unconditional. The contract simply provided that when Herring should terminate his employment, whether voluntarily or otherwise, he would be entitled to the full sum credited to his profit-sharing account. The employee's vested interest in the plan has all the attributes of property, and we hold that it was property at the time of the divorce.

For the same reasons the annuity contract was also property at the time of the divorce. *Herring v. Blakeley*, 385 S.W.2d 843, 845 (Tex. 1965).

² Under Int. Rev. Code of 1954, §§ 401-404 and 501, if a deferred compensation plan "qualifies," the employer can deduct his contributions to the fund in the year in which they are made, while the employee is not taxed in that year, but in a later year when he actually receives distributions from the fund. Thus, the employer is allowed to deduct the cost of providing a pension plan for the employee, while the employee is not taxed until he receives the income after retirement. Generally, in years after retirement, income is less and tax rates lower. It should also be noted that § 501(a) also provides, as a part of

plans have grown at an astonishing rate. According to recent figures, private pension plans contain over \$50 billion in assets.³ It is becoming increasingly evident that in this age of the paternalistic corporation the right to participate in such a plan may often be a family's most important asset.⁴ Due to the gigantic size of these funds and their relatively recent origin, they raise serious and unsettled questions in a social as well as a legal context. The essential question is one of ownership. Who really "owns" the assets of these new and grand economic balloons? The trustee pilots them; but, by definition, he has no equitable interest in the assets. Employers blow them up; but they generally do not "own" them, because in order for the contributions to be deductible in computing taxable net income the plans must be maintained for the exclusive benefit of employees or their beneficiaries, with safeguards against diversion.⁵ The beneficiaries ride in them; but for various reasons they usually possess few incidents of ownership.⁶ "Thus, there exists a large and rapidly-growing body of wealth which is owned by no one in particular, at least in terms of any conventional notions of ownership or property rights."⁷ To compound the confusion, the law of Texas, and other community property jurisdictions was, until now, quite undeveloped with respect to community rights in such plans. Prior to the present case, there existed no Texas authority squarely meeting the problem of the status upon divorce of so-called "unmatured interests" in such funds.

Before attempting to analyze the various situations which may arise under deferred compensation plans in the field of community property, a few definitions are called for. Under most of these plans, three sets of rights may accrue to the employee. First, at some point during his period of employment the employee usually acquires certain vested rights in the corpus of the fund. Although these rights are generally circumscribed by spendthrift provisions, they are vested and may not be lost by any act of the employer or trustee. These

the public policy to encourage retirement funds, that all *income* to the trust is exempt from taxation. It is clear, even from this brief sketch, why such funds have increased at a phenomenal rate in recent years.

³ SEC Securities Act Release No. 1750, Dec. 31, 1961.

⁴ Johnson, *Retirement Benefits as Community Property in Divorce Cases*, 15 *Baylor L. Rev.* 284 (1963).

⁵ Treas. Reg. § 1.401 (1964).

⁶ Almost universally such plans are drawn by the employer, and, for ease of administration, as much control is reserved to the trustee as is consistent with "qualification" under Int. Rev. Code of 1954, § 401. For example, in the profit sharing plan involved in the present case we find such provisions as: "Such allocations, credit and notification shall not vest in any participant any right, title or interest in the trust, except at the time or times, and upon the terms herein provided and shall not create any liability against the company, subsidiaries, committee or trust except to the extent expressly provided."

⁷ Blackburn, *Economic Aspects of Pension Plans*, 27 *Law & Contemp. Prob.* 89, 94 (1962).

rights are analogous to the *policy rights* under conventional life insurance policies such as the cash surrender value and the right to borrow against the interest. Second, at retirement (or at other times, according to terms of the individual plan) the employee will acquire a right to specific pension payments, usually to be made at periodic intervals. This feature is peculiar to pension and annuity plans, and may be referred to as the *income right*. Third, the employee generally has a right to designate a death beneficiary. This right is analogous to the *proceeds right* under a life insurance policy. For convenience, the various bundles of employee rights in compensation plans will be denominated "policy rights," "income rights," and "proceeds rights."

Two theories have been advanced in support of the proposition that deferred compensation plans, such as those involved in the present case, should be deemed the separate property of the employee-spouse. Both of them appear to be untenable. First is the proposition, stemming from older cases,⁸ that, "where the funds are wholly provided by the company for the retirement plan, the courts have held that such an undertaking is a charitable enterprise."⁹ The legal inference from this analysis is that there was a gift to the employee-spouse and as a gift it is the separate property of the donee.¹⁰ The obvious answer to this is that no matter how much discretion over the funds is retained by the employer,¹¹ it is the *sine qua non* of every such plan that the rendition of services by the employee is a prerequisite to any benefit under the plan. It has long been held that whatever benefits arise as a direct consequence of one spouse's employment during marriage are community property.¹² This is the approach taken by the court in the *Herring* case.

A second argument for considering such plans separate property is based upon the fact that deferred compensation plans are generally circumscribed by spendthrift clauses.¹³ Thus, in the court of civil

⁸ E.g. *Aston v. Magnolia Petroleum Co.*, 241 S.W.2d 306 (Tex. Civ. App. 1951) *error ref.*; *Webster v. Southwestern Bell Tel. Co.*, 153 S.W.2d 498 (Tex. Civ. App. 1941) *error ref.*; *Dowling v. Texas & N.O.R.R.*, 80 S.W.2d 456 (Tex. Civ. App. 1935) *error ref.*; *Spiner v. Western Union Tel. Co.*, 73 S.W.2d 566 (Tex. Civ. App. 1934) *error ref.* It should be noted that all of these cases deal with rights between employer and employee and none of them involve problems of community property. See, generally, Annot., 42 A.L.R.2d 461 (1955).

⁹ *Blakeley v. Herring*, 374 S.W.2d 677, 681 (Tex. Civ. App. 1964). The supreme court, in reversing this in the present case, specifically overrules the assertion quoted in the text.

¹⁰ Tex. Rev. Civ. Stat. Ann. art. 4613 (1960).

¹¹ If the plan is to "qualify" under the Internal Revenue Code total discretion cannot be left in the employer. See notes 2 and 4 *supra*.

¹² *Lee v. Lee*, 112 Tex. 392, 247 S.W. 828 (Tex. Comm. App. 1923); *Kirkham v. Kirkham*, 335 S.W.2d 393 (Tex. Civ. App. 1960). Notice that this statement holds good no matter what form of deferred compensation plan is involved.

¹³ One such clause involved in the present case reads:

None of the benefits, payments proceeds, or claims of any participant shall

appeals opinion in the present case the argument was made that because at the time of divorce the husband had no interest in the funds that he could assign or otherwise dispose of under the plan, the wife was excluded from any community share of the interest in the plan accumulated by the husband.¹⁴ This view amounts to an assertion that, by an agreement between a husband and his employer, the nature of compensation can be changed from community to separate by merely delaying payment until after divorce. It is doubtful that a Texas court would allow an employer to pay a husband's wages into a spendthrift trust to the benefit of the husband and thus deny the community any interest;¹⁵ yet this is precisely the result obtained when the employer pays money into a trust fund while the employee-husband perfects his right to benefit in the fund by rendering service to the employer.

Although no prior Texas case is directly in point, it may be helpful to note three cases which may indicate the direction of future development in the area. First, and most important, is the recent case of *Kirkham v. Kirkham*,¹⁶ in which it was held that at divorce a wife was entitled to a share of the husband's "income rights" under his Army pension. The pension had been earned over a twenty-two and one-half year period of service, the closing twelve and one-half years of which were spent during marriage. Upon divorce, the wife was awarded a thirty per cent interest in the periodic income payment.¹⁷ As authority for its decision sustaining a money judgment against the husband for the wife's share of future payments, the court cited *Berg v. Berg*.¹⁸ In *Berg*, however, it is not clear whether the court held that the wife had a community interest in the husband's "income rights" under a railroad pension by reason of marriage during the last one-sixth of the period during which the pension was earned, or whether the court merely sustained an exercise of discretion by the trial court in providing support for the wife out of

be subject to any claim of any creditor of any participant and, in particular, the same shall not be subject to attachment or garnishment or other legal process by any legal creditor of any participant, nor shall any such participant have any right to alienate, anticipate, commute, pledge, encumber or assign any of the benefits or payments or proceeds which he may expect to receive, contingently or otherwise, under this agreement. *Blakeley v. Herring*, 374 S.W.2d 677, 680 (Tex. Civ. App. 1964), rev'd, 385 S.W.2d 843 (Tex. 1965).

¹⁴ *Ibid.*

¹⁵ The point is, of course, that the *nature* of the vested interest is determined, as a matter of law, as of the moment it arises—*i.e.* it is either separate or community, and no amount contracting should be allowed to negative the constitutional intention that certain property interests should be community under certain fact situations. See note 26, *infra*.

¹⁶ 335 S.W.2d 393 (Tex. Civ. App. 1960).

¹⁷ Note, however, that in *Kirkham* the pension was vested *and matured* at the time of the divorce.

¹⁸ 115 S.W.2d 1171 (Tex. Civ. App. 1938) *error dismiss.*

the husband's separate estate under "the right of a trial court to provide for the divorced wife's support out of the separate estate of the former husband. . . ."¹⁹ The third important case, *Allen v. Allen*,²⁰ must be closely analyzed in order to determine what it does not hold, for it is easy to misinterpret the opinion as authority for the proposition that a nonemployee spouse never has an interest in a deferred compensation plan that has not yet matured. What the case does hold is that under the provisions of the Railroad Retirement Act of 1937²¹ a spouse of an employee is barred from any interest in an unmatured plan. It is pointed out that the case involves the effect of federal exemptions, not private spendthrift provisions, and should be limited to its special facts.²²

Although the issue was not before the court in the present case, it should be noted that in the only two Texas cases considering the problem,²³ the separate or community nature of "income rights" was determined by applying the so-called "tracing principle" rather than the rule of "inception-of-title."²⁴ Thus, in cases in which the interest

¹⁹ *Id.* at 1172.

²⁰ 363 S.W.2d 312 (Tex. Civ. App. 1962).

²¹ 50 Stat. 309 (1937), as amended, 45 U.S.C. §§ 228a-228z (1958). Section 228a (1), quoted in *Allen*, reads: "Notwithstanding any other law of the United States, or of any State, Territory, or the District of Columbia, no annuity or pension payment shall be assignable or be subject to any tax or to garnishment, attachment, or other legal process under any circumstances whatsoever, nor shall the payment thereof be anticipated."

²² As to the effect that federal exemptions may have upon community and family rights in pension plans, the *Allen* case appears to be in conflict with *Dillard v. Dillard*, 341 S.W.2d 668 (Tex. Civ. App. 1960) *error ref. n.r.e.*, which held that similar exceptions of benefits paid by the Veteran's Administration were not exempt for purposes of child support payments. This conflict is discussed in Johnson, *supra* note 4, at 288. See generally Annot., 54 A.L.R.2d 1422 (1957).

²³ *Kirkham v. Kirkham*, 335 S.W.2d 393 (Tex. Civ. App. 1960); *Berg v. Berg*, 115 S.W.2d 1171 (Tex. Civ. App. 1938) *error dismiss.*

²⁴ These terms were popularized (and possibly coined) by Prof. William O. Huie. For a recent discussion by Professor Huie of problems involved in Community ownership of life insurance (to which a close analogy is drawn in the closing sections of this Note) see Huie, *Community Property and Life Insurance—Substantive Aspects—Developments in Texas, in Texas Institutes*, 2 Business and Family Planning 104 (1957).

The two theories may be defined as follows: (1) Under the "tracing rule," ownership of property is classified as community or separate according to the nature of the consideration given in exchange for it. For example, in the leading case of *Love v. Robertson*, 7 Tex. 6, (1851), the husband bought two slaves after marriage. One, Peter, was purchased entirely with the husband's separate funds. The other, Finn, was bought with mixed funds, \$330 separate and \$470 community. It was held that Peter was separate property of the husband and Finn was owned by "mixed title"—330/800ths separate and 470/800ths community. The theory was that the characterization of property is not changed by a change in form. (2) However, a problem often arises as to the point of time when property is to be characterized, after which tracing establishes a right of reimbursement rather than part ownership. For example, in *Love*, if the husband had taken title to Finn prior to marriage but owing \$470 on the purchase price, and then after marriage had paid the debt with community funds it is almost certain that Finn would have remained separate property and the community, instead of getting part ownership, would have had only a right to reimbursement. Under this set of facts we would see an example of "inception-of-title." See the leading case of *Welder v. Lambert*, 91 Tex. 510, 44 S.W. 281 (1898). *But cf.* Sparks v. Taylor, 99 Tex. 411, 90 S.W. 485 (1906).

was incepted prior to marriage, but perfected during the existence of the community, the community was given part ownership of the "income" in the proportion that community funds or services were used to obtain the interest. Under the "inception of title" rule, separate ownership would have been given to the employee-spouse in the principal case if the plan had been entered into prior to marriage. The community, however, would have had a right to reimbursement for its contributions to the maintenance and perfection of the plan. It is believed that the "tracing" rule is more just and more easily applied,²⁵ and it is suggested that it should be extended to cover not only "income rights" but also "policy rights."²⁶ It should be pointed out that in the present case (a "policy rights" situation), no matter which rule is applied, the entire interest should be community because title was incepted subsequent to marriage and all "payments" were made either with community funds or by the exertion of community effort. The problem will become more acute when more cases arise in this area.

Thus, the present case settles several basic problems. First, it is now clear that spendthrift provisions in deferred compensation plans do not affect the characterization of the property interest as separate or community. This is entirely consistent with the long-standing Texas rule that the character of property as separate or community is fixed by operation of law upon certain facts²⁷ rather than by the present intention²⁸ or even the ante-nuptial contract²⁹ of the parties. Second, it is now apparent that these plans will be analyzed realistically³⁰ and that the idea that they amount to a gift by the employer will be discarded. This is also consistent with prior but rather unsettled

²⁵ Indeed, in a "income rights" situation where the main community asset is a matured pension income it would be most difficult to frame a decree under the "inception-of-title" rule. The asset is a periodic payment. It is simple to divide such a payment on a percentage basis according to the percentage of property or services (community or separate) used to mature the pension right. It is correspondingly difficult to attempt a schedule of reimbursement to the nonbeneficiary spouse for his share of community property used to maintain the separate pension plan during the years of marriage subsequent to the original inception of title.

²⁶ For an example of the "tracing principle" at work in a life insurance "policy rights" situation see *Berdoll v. Berdoll*, 145 S.W.2d 227 (Tex. Civ. App. 1940) *error dismissed*. But cf. *McCurdy v. McCurdy*, 372 S.W.2d 381 (Tex. Civ. App. 1963) *error ref.*, noted in 18 Sw. L.J. 521 (1964), a "proceeds" case, in which the inception-of-title rule was firmly adopted. Although *McCurdy* can be distinguished as a "proceeds" case, one may speculate that the rule will be extended to cover surrender value in "policy rights" situations. However, for reasons stated above, and under the influence of *Kirkham* and *Berg*, it is believed that "tracing" is, and will remain, the rule in "income" situations.

²⁷ *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902).

²⁸ *Cox v. Miller*, 54 Tex. 16 (1880); *Brokaw v. Collett*, 1 S.W.2d 1090 (Tex. Comm. App. 1928).

²⁹ *Goreman v. Gause*, 56 S.W.2d 855 (Tex. Comm. App. 1933).

³⁰ It is largely though the grace, not of the gift tax law, but of the income tax law, that such plans exist at all. See note 1, *supra*.

authority.³¹ Third, *Herring* makes explicit the fact that a vested interest in an unmatured,³² deferred compensation plan is property for purposes of Texas community property law.

In summary, four situations may be envisioned upon dissolution of a community which holds interests in a deferred compensation plan:

(1) First is the case of dissolution by divorce (or death of the nonemployee spouse) where there is a present, matured "income right." This is the *Kirkham-Berg* situation, and it may be asserted with a relative amount of confidence that if the community existed during part or all of the period of accrual then part or all of the income is community property and is divisible as such at dissolution.

(2) Second, and slightly more difficult, is the situation in the *Herring* case, in which the employee-spouse has an unmatured but vested interest, capable of valuation but generally circumscribed by spendthrift provisions, and unavailable to the employee except by severance of employment short of maturity of the plan, *i.e.*, the "policy right" situation. It is believed that whether or not this interest is community property should be determined by application of tracing principles, the private spendthrift terms of the contract are irrelevant in determining the community or separate nature of the interest, and such an interest should be treated at dissolution as analogous policy rights are treated under similar circumstances involving life insurance—*i.e.* they should be divisible.³³

(3) Third is the case of dissolution by death of the employee spouse, with proceeds going to a beneficiary designated in the contract. Here it is submitted that the plan should be treated precisely as a life insurance policy under similar circumstances. Following life insurance principles, the proceeds would clearly be property,³⁴ but would be subject to gift by the employee-spouse to a third (non-community) party by naming such party beneficiary under the provisions of the plan.³⁵ However, such a gift would always be subject to attack as a fraud (or constructive fraud) upon the community if the size of the gift were disproportionate with the size of the total estate.³⁶

³¹ *Lee v. Lee*, 112 Tex. 392, 247 S.W. 828 (1923).

³² An "unmatured" plan, as the term is understood in this note, refers to any deferred compensation plan which is not perfected—*i.e.*, one which must have some additional event occur before it will begin pension payments or pay death benefits. Thus a plan may be "unmatured" although vested. This was the situation in the present case.

³³ *Cox v. Cox*, 304 S.W.2d 175 (Tex. Civ. App. 1957).

³⁴ See *Brown v. Lee*, 371 S.W.2d 694 (Tex. 1963), noted in 18 Sw. L.J. 133 (1964).

³⁵ *Volunteer State Life Ins. Co. v. Hardin*, 145 Tex. 245, 197 S.W.2d 105 (1946); *Martin v. McAllister*, 94 Tex. 567, 63 S.W. 624 (1901).

³⁶ *Kemp v. Metropolitan Life Ins. Co.*, 205 F.2d 857 (5th Cir. 1953), *on second appeal*,

(4) Last is the situation in which the employee-spouse has a certain interest in the plan, but the interest remains unvested and is not susceptible of valuation. Here it must be suggested that such interest, although possibly contingently valuable and although obtained through community means, is not property but rather a mere expectancy and as such not divisible at dissolution of the marriage.³⁷

In the first and second situations mentioned above an additional difficulty is encountered in drafting an appropriate divorce decree. This difficulty stems from the fact that although a major portion of the community's economic worth is vested in a deferred compensation plan, it may be difficult to divide equitably the value and the risks of the plan. These plans are so varied in their terms, each having been drafted to meet a different set of circumstances, that it is impossible to suggest any single rule or method of division that would be equitable in every situation. To compound the difficulty, these plans, unlike life insurance, generally have no immediate cash surrender value. It must be remembered that the formulation of the decree must also depend upon such contingencies as the availability of other assets, the overall economic situation of the community and the existence of children. Because the facts in individual cases will be quite diverse, Texas divorce courts must use wisely their extremely broad discretionary powers in matters concerning division of property at divorce.³⁸ It is suggested that no hard and fast rule can or should be laid down in this area, that each case be made to turn upon its own equities, but that *in general* the value of the deferred compensation plan should be distributed by way of an *in personam* decree against the husband, on which the wife could bring suit and become a judgment creditor.

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220 F.2d 952 (5th Cir. 1955); *Martin v. Moran*, 11 Tex. Civ. App. 509, 32 S.W. 904 (Tex. Civ. App. 1895). It should be kept firmly in mind that the present case is concerned with "policy rights" at the time of divorce. The intervening death of the husband-beneficiary should not be allowed to cloud the issue with irrelevant considerations of "proceeds rights."

³⁷ *McBride v. McBride*, 256 S.W.2d 250 (Tex. Civ. App. 1953).

³⁸ For an example of such a decree in an analogous situation see *Coleman v. Coleman*, 348 S.W.2d 384 (Tex. Civ. App. 1961) *error dismissed*, in which the interest of a divorced wife in an endowment educational insurance policy for benefit of a minor child was fixed as of the date of the divorce and, in the event of ultimate cancellation, one half of the cash surrender value of the policy *as of the date of the divorce* would vest in the wife.