

Multiple Choices:

Property Rights and Individual Accounts

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1. Introduction

At first glance, individual retirement savings accounts look simple. Each account belongs to one person and contains a pool of assets produced by accumulated contributions and their earnings. After retirement, the assets in the account are paid out over time with the size of the account determining the amount of income produced. What could be simpler?

Individual accounts *are* simple but only until a spouse or dependent child enters the picture. Then more than one person has a potential claim against the account. Adding individual accounts to Social Security is controversial, in part because many fear accounts will fail to generate adequate retirement income because of poor investment choices or low levels of contributions. But even if accounts grow as intended, changes in the family pose an equal, if not greater, threat. At best, individual accounts are a zero sum game. Their assets are finite. When the account must be divided, what one person wins, another person loses. Family events such as divorce and death may precipitate division and distribution of account assets, considerably reducing the available retirement income.

Social Security does not currently have a system to define and allocate competing interests to benefits. To implement individual accounts, a system of property rights must be created to manage the inevitable conflicts between the needs of the individual for retirement income and other members for support. The risk is that a system with poorly-designed family property rights will dissipate account assets prematurely. It may also cause prolonged disputes or expensive litigation that will consume account assets, leaving little for the intended beneficiaries.

This paper begins a discussion of the appropriate property rights system for individual accounts in Social Security. It does not offer a prescription - that would be premature, given how few details of an individual accounts program have been settled. Instead, using some familiar retirement schemes as models, it analyzes the following basic issues that must be resolved.¹ What property rights should individual accounts have? Who should hold those rights? When and how should those rights attach to benefits? How should those rights be enforced? It also suggests these guiding principles:

1. Borrow the best features of existing models. There's no need for an entirely original approach.
2. Recognize the needs of family members from the start. But remember that retirement income is the primary objective of individual accounts.
3. Define rights and remedies clearly and comprehensively. This will minimize disputes.
4. Resolve disputes through an administrative claims process. Litigation should be the last resort.
5. Use federal law. Rights should be the same no matter where people live.

2. Property Rights in General

Although the term “property rights” is a familiar one, it is surprisingly difficult to define. The operative words, “property” and “rights,” each derive their meaning from the system of law in which they are embedded, and systems of law vary from country to country and from one era to another (Cunningham, Stoebuck and Whitman 1993). For purposes of this paper, the most relevant property rights concepts are found in Anglo-American law, a system based upon principles of law developed in England in feudal times.²

There is no single statute which provides a comprehensive definition of property. As one court recently noted,

The word ‘property’ is in law a generic term of extensive application. It is not confined to tangible or corporeal objects, but is a word of unusually broad meaning. It is a general term to designate the right of ownership and includes every subject of whatever nature, upon which such a right can legally attach. It ... is employed to signify any valuable right or interest protected by law and the subject matter or things in which rights or interests exist.

(*Mears v. Mears* 1991).³ Judges usually decide what is and is not a property right by interpreting the relevant statute or adapting general common law principles. The standards used vary from case to case.

As the definition above indicates, there are three concepts which define “property” in a legal sense.

First, there must be some subject matter or “thing” identifiable as property. This is not a difficult standard to satisfy because almost any “thing,” either tangible (land, goods) or intangible (a mortgage, an easement), will qualify. Second, there must be some interest, expectation, privilege or right which attaches to the property. This is also not a difficult standard as most property is composed of multiple interests. Typical interests are the right to use, the power to sell, the right to devise by will, the right to mortgage, the right to possess, the right to exclude all others, the right to lease property and so on. Depending on the type of property, these interests can be held and allocated in an almost infinite number of combinations. For example, one person can hold all interests in a particular property and a single interest can be held by several persons jointly.

a professional degree	no, it is unique to the individual, can't be sold or transferred
tangible objects such as land, buildings	yes, they can be sold, leased, devised by will, mortgaged etc.
intellectual property such as copyrights, trademarks	yes, statutes determine rights
a future inheritance	no, it is too speculative
financial assets such as stocks, bonds, bank accounts	yes, statutes and common law determine rights

Third, and most important, the law must be willing to enforce and protect a particular interest or it is not a property right.

Property rights in the United States are particularly complicated because there are two sets of laws - federal and state - which often overlap and sometimes conflict. A substantial body of federal law, largely statutory, governs the rights to such property as copyrights, trademarks and patents. Federal law sometimes has exclusive jurisdiction but, in other cases, it leaves the field completely open to state law. Each state has its own system for determining property rights. Where federal law conflicts with state law, federal law generally prevails.

3. Theories of Property Rights and Retirement Benefits

Retirement benefits are a peculiar form of property. They are compensatory in nature, that is, they are derived from compensation (e.g., wages or salary) earned through an employment relationship. Although retirement benefits are earned along with wages and salaries, they are really deferred compensation - earned now but paid later. This time lag can create difficult property rights issues, particularly between married and formerly-married individuals. Conflicts over deferred compensation are most apt to arise at three events: distribution (when benefits begin to be paid); divorce; and death.

The right to control compensatory property depends on two factors: (1) the marital status of the recipient, both now and then; and (2) the law - federal law, state law or a combination - that applies. For single people, a simple rule applies. It is their sole property to dispose of as they wish unless, for example, there is a child support order attaching their pay. The same rule generally applies when never-married people receive retirement benefits. Federal and state laws have little effect on the rights of single people to their compensation.

But married people present a more complicated case. In most societies, the marital unit is special. Married people enjoy special privileges but they also have special responsibilities towards each other (The American Law Institute 1997; Tingley and Svalina 1999; and Turner 1994). Special systems of property rights, known as marital property rights, apply to married persons and control how their property is treated at divorce, at death and sometimes even during the marriage. In the United States, these rights can be particularly complicated because of the interaction of federal and state law. Usually state law predominates. Federal law has no general theory or common law of marital property rights. If it applies, a specific statute will generally contain specific rules for its own unique purposes. When state law applies, marital property rights are determined by the marital property system in effect where the couple resides.⁴ No two states have identical systems, but all states can be grouped into two general categories. States within a particular category, however, can have widely varying rules.

Most states follow the English common-law tradition that property owned by a spouse is individual property unless it is held in joint ownership. Under this system, married persons own their compensation during the marriage, unless it is held in a joint account, and are free to leave it by will to anyone. At

Table 2. Marital Property Law Systems		
Treatment of Property	Common Law States	Community Property Law States
Acquired before marriage	separate property	separate property
Acquired during marriage	separate property unless held in joint ownership	joint ownership in community property
At divorce	separate and joint property divided "equitably" between the spouses	community property divided equally between the spouses
At death	separate and joint property interests devisable by each spouse	community property interests and separate property devisable by each spouse

divorce, however, it is subject to being allocated to the other spouse by a judge under a principle of "equitable distribution." Under this system, and assuming that no contrary law applied, retirement benefits would belong to the spouse who earned them, subject to allocation to the other spouse at divorce.

Eight states, however, have adopted the European tradition of community property which treats a marriage as an economic partnership between the spouses. This system assumes that both spouses contribute equally to the marriage. Both spouses have equal ownership in all property acquired during the marriage, including compensation, which actually belongs to an entity called the marital community.⁵ Under this system, and again assuming that no contrary law

applied, both spouses share equally in and have a right to manage retirement benefits earned during the marriage, receive their 50% interest at divorce, and choose a beneficiary for their 50% interest at death.

4. Potential Property Rights Issues In Individual Accounts under Social Security

All proposals for individual accounts under Social Security have a common feature - a plan to pay a portion of every individual's contribution into a personal account rather than into general Social Security funds. But how these accounts will be structured and administered is totally unresolved. Some proposals require Social Security to act as custodian and administrator of accounts; others anticipate that financial services companies in the private sector - banks, mutual funds and insurance companies - would perform these functions. Some restrict permissible investments to a limited number of funds offered through the federal government; others make private sector investment options available. Some require account balances to be annuitized at retirement; others permit other forms of payment. Some require benefits to be paid from individual accounts at retirement under current Social Security definitions; others permit greater flexibility on the timing of benefit payments.

With so much uncertainty, it is unclear what property rights will actually apply to these accounts. It seems reasonable to assume, however, that any final program will permit individuals to decide how their accounts will be invested, set flexible deadlines for when benefits may be paid and offer both annuity and other forms of payment, including some with survivor benefits.⁶ If so, these accounts are likely to provide individuals with the following core set of property rights:

- P the right to choose and change investments
- P the right to choose when benefits will be paid after retirement
- P the right to choose how benefits will be paid
- P the right to choose a beneficiary.

It is more difficult to predict what rights a spouse will have. The possibilities include:

- P the right to co-exercise individual rights
- P the right to consent to a spouse's choices
- P the right to a portion of the account at divorce
- P the right to attach the account for unpaid child support or alimony
- P the right to inherit all or a portion of the account on the spouse's death.

Children may also have some rights to these accounts. Such rights may include:

- P the right to inherit a portion of a parent's account
- P the right to attach the account for support while a dependent.

An enforcement scheme will be required for the property rights system created for individual accounts. The most important decision to be made is what body of law controls. If based on federal law, the actual provisions of the authorizing statute, rather than general legal principles, control. That statute could define property rights in any number of ways. If based on state law, the enforcement scheme would have to be integrated with the laws of the fifty states and able to resolve the issues arising when the laws of several states conflict.

5. Three Alternative Models to Consider

In the U.S. today, there are three primary systems for delivering retirement benefits: Social Security; the private pension system; and individual retirement accounts (IRAs). Two of these - the private pension system and IRAs - have substantial experience with individual accounts. These systems differ markedly in the rights provided to individuals and family members. In order to build a property rights system for individual accounts under Social Security, it is useful to learn how these systems have resolved the following issues. What property rights do individuals have in these systems? Do family members have property rights? If so, when and how do their rights attach to benefits? How are these rights enforced?

Individual Property Rights to Benefits

Social Security: Most Americans would be surprised to learn that there are no protected property rights in Social Security benefits today.⁷ The program was designed with the philosophy of providing workers with benefits as a matter of right. It was not intended to be a welfare program, equivalent to the dole or subject to a means test. As noted at the time of its enactment,

[Social Security] comports better than any substitute we have discovered with the American concept that free men want to earn their security and not ask for doles - that is what is due as a matter of earned right is far better than a gratuity ... Social Security is not a handout; it is not charity; it is not relief. It is an earned right based upon the contributions and earnings of the individual. As an earned right, the individual is eligible to receive his benefit in dignity and self-respect.⁸

The Supreme Court, however, disagreed in *Flemming v. Nestor* (1960). It ruled that individuals have a statutory entitlement but no property right to their benefits.⁹ Because Social Security benefits depend on earnings records rather than contributions, unlike annuity payments which depend on premium payments, the Court concluded that individuals have no contractual right to benefits. The Court also seemed persuaded that individuals' benefits are never "vested," that is, individuals do not have an ownership right to a specific benefit amount which the law can enforce. It noted that Congress reserves the right to "alter, amend or repeal" the program at any time which means that it has the right to change the benefits structure, even retroactively.¹⁰ Noting that the program was intended to last for the foreseeable future, it reasoned that

to engraft upon the Social Security system a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands.

Under *Nestor*, then, Social Security benefits are not property. No individual has a legally enforceable right to a particular amount of benefit payable at a particular point in time. Although employers and employees

finance Social Security with their contributions, the benefits promised by the program are a mere expectancy, subject to the will of Congress.

Private pension system: The private pension system does have a well-developed system of property rights.¹¹ Benefits are earned through employment, and employers decide the benefits their employees will have when they choose to sponsor a particular type of plan.¹² Individuals who participate in the plan accrue benefits over time. Depending on the plan's schedule, they become "vested" in those benefits over time. Under tax code rules, individuals must become fully vested after five years, if the plan has an all-or-nothing vesting schedule, or after seven years, if the plan grants vesting credit over a number of years. Once vested, benefits accrued cannot be lost or forfeited. Even if employers change the plan, vested benefits must be protected.¹³ In a defined benefit plan, this generally means that individuals have a right to a certain amount of income at retirement. In a defined contribution plan, this means only that individuals have a right to the employer contributions previously made to their accounts, not that they are guaranteed the value of their accounts at any point in time. Employees are always 100% vested in their own contributions.

IRAs: IRAs are extremely simple.¹⁴ Individuals fund these accounts through their own contributions or by rolling over benefits they have earned under an employer-sponsored plan. Individuals always have a 100% vested interest in the assets in their IRAs, even though the value of their accounts may fluctuate from time to time due to investment performance.

Family Property Rights to Benefits

Social Security: The absence of property rights in Social Security has little practical effect due to the current design of the program. For example, the program pays benefits only in the form of life annuities so there are no inheritance questions. It also includes auxiliary benefits for spouses, including certain divorced spouses, as well as dependents. Family members do not compete for benefits under Social Security today. Instead, if they satisfy eligibility standards, they are entitled to benefits independently. In large part, this reflects Social Security's designation of the family, rather than the individual, as the fundamental unit for defining benefits.

Figure 1 illustrates how family benefits are allocated under Social Security today. Individuals earn benefits based upon their earnings history. When distributions begin, individuals receive 100% of their benefit as an annuity payable for life. A spouse may also have an earned benefit. But a spouse also has a right under Social Security's dual entitlement system to a minimum benefit of 50% of the other spouse's benefit, if greater than the earned benefit. A surviving spouse is also entitled to a minimum benefit of 100% of the deceased spouse's benefit, if greater than the earned benefit. Spouses also receive benefits in the form of an annuity payable for life. Divorced spouses also are entitled to a minimum benefit based on their former spouse's earnings history, if they were married for at least 10 years and have not remarried. The benefit of a divorced spouse is calculated based on the former spouse's entire earnings history, not just the portion represented by the marriage. Social Security also provides benefits for dependent children based on a parent's earnings history.

Figure 1. Family Benefits Under Social Security Today

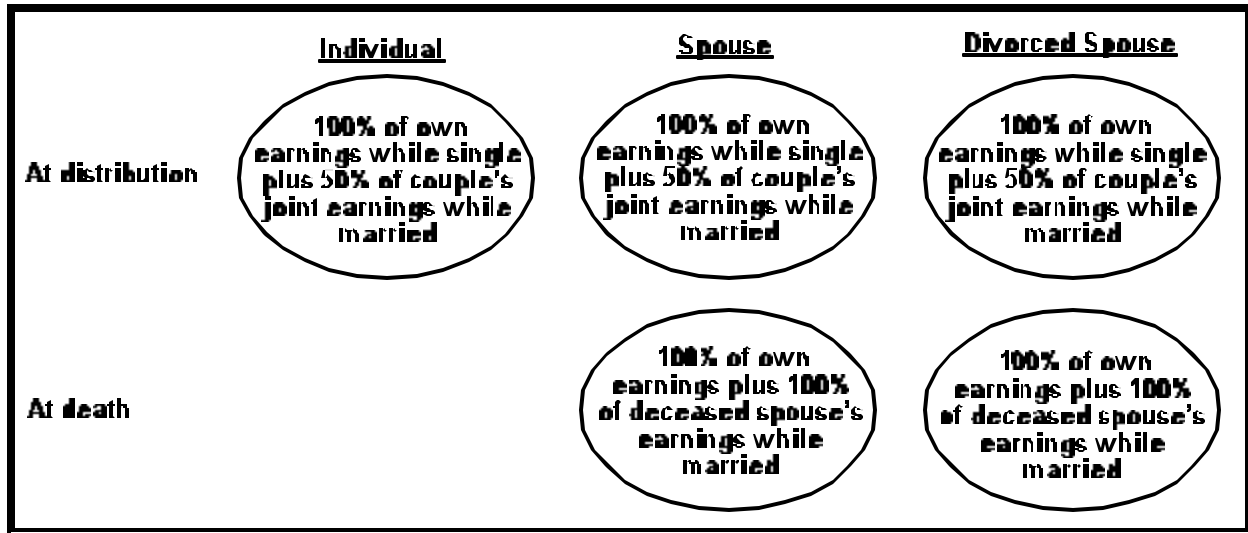
	<u>Individual</u>	<u>Spouse</u>	<u>Divorced Spouse</u>	<u>Dependent Child</u>
At distribution	100%	at least 50% of spouse's benefit	at least 50% of former spouse's benefit	up to 50% of deceased parent's benefit
At death		at least 100% of deceased spouse's benefit	at least 100% of deceased former spouse's benefit	up to 75% of deceased parent's benefit

These family benefits have at least three unusual aspects that an individual account plan cannot replicate. First, individuals can generate multiple additional benefits, based on their earnings history, without experiencing a reduction in their own benefits. Second, an individual's earning history, not the number of benefits it generates, determines the rate of contributions. Married workers or workers with dependent children do not pay extra for these benefits. Third, Social Security family benefits are not just survivor benefits. Spouses and divorced spouses, depending on their ages and other circumstances, and dependent children are entitled to be paid concurrent benefits.

It is useful to mention briefly an alternative scheme for defining family benefits that has often been proposed for Social Security. This proposal, called "earnings sharing," is interesting because it would essentially transform Social Security into a community property system. In addition, Social Security's traditional emphasis on the family unit would change, and the dual entitlement system would no longer be available (Reno and Upp 1983; Center for Women Policy Studies 1988).

Figure 2 illustrates how family benefits could change under an earnings sharing system. Each spouse would receive a Social Security benefit based in part on his or her earnings while single. While married, the earnings of the spouses would be combined, and each spouse would receive credit for 50% of the couple's joint earnings. Each spouse would retain those credits on divorce. Under this system, some benefits would no longer be available. Divorced spouses, for example, would no longer receive a benefit based on their former spouse's entire earning history. Instead, they would receive credit only for the duration of the marriage. Family benefits would continue to be paid concurrently, however, and in the form of life annuities.

Figure 2. Social Security Benefits With Earnings Sharing

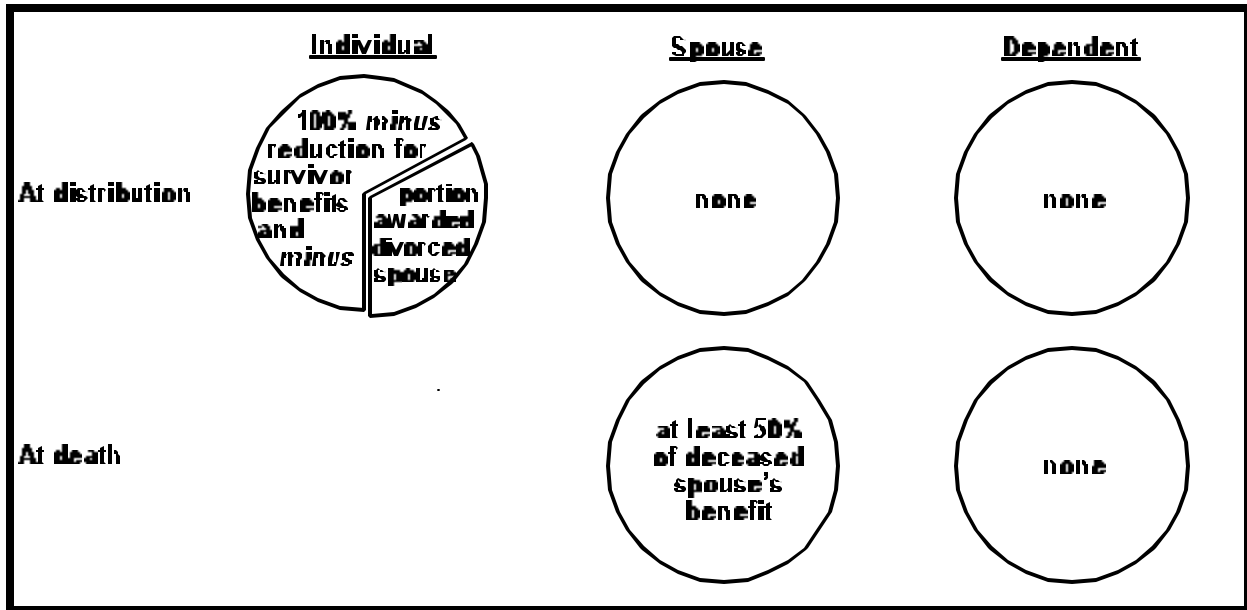


Private Pension System: The private pension system is designed to provide benefits to individuals, not to families. Only one additional person - the surviving spouse - has any property rights to benefits, and even those rights are limited. When the Employee Retirement Income Act of 1974 (“ERISA”) was enacted twenty-five years ago, it enabled individuals to protect their vested benefits from loss caused by mismanagement of the plan or its assets or the actions of the plan sponsor. But the spouse’s potential interest in those benefits was not protected. Individuals had the unilateral right to decide how their benefits would be paid. They were generally free to choose, for example, between an annuity that could provide survivor benefits for a spouse and an annuity that did not. Ten years after ERISA was enacted, it became apparent that the absence of rights for spouses was a problem. Many women found themselves impoverished as widows because their husbands had chosen a life annuity or a lump sum payment which was then spent. In addition, because their rights were unsettled under ERISA, many divorced spouses received no share in the benefits accrued by their former spouses during their marriages.

The Retirement Equity Act of 1984 (“REA”) amended ERISA to provide some minimal rights for spouses.¹⁵ Briefly, a plan must now honor an award of benefits to a former spouse at divorce. In addition, spouses now have some limited rights to benefits on the death of their spouse. But true survivor benefits are required in only a limited number of plans. These plans - defined benefit plans and defined contribution plans known as money purchase plans - are now required to pay benefits as annuities with survivor rights. Participants may choose a different form of payment or name someone other than the spouse as beneficiary but only with the spouse’s written consent. Spouses must also consent to any distributions, such as a loan, made to participants before retirement benefits begin. These rights, however, only apply to the surviving spouse. A predeceased spouse generally loses all rights to a spouse’s benefit at death, including the right to consent to a successor beneficiary.¹⁶

Figure 3 illustrates how REA’s survivor annuity requirements are intended to work. In these plans, individuals are generally not entitled to begin receiving benefits until they retire at normal retirement age (age

Figure 3. Family Rights to Annuity Benefits in the Private Pension System

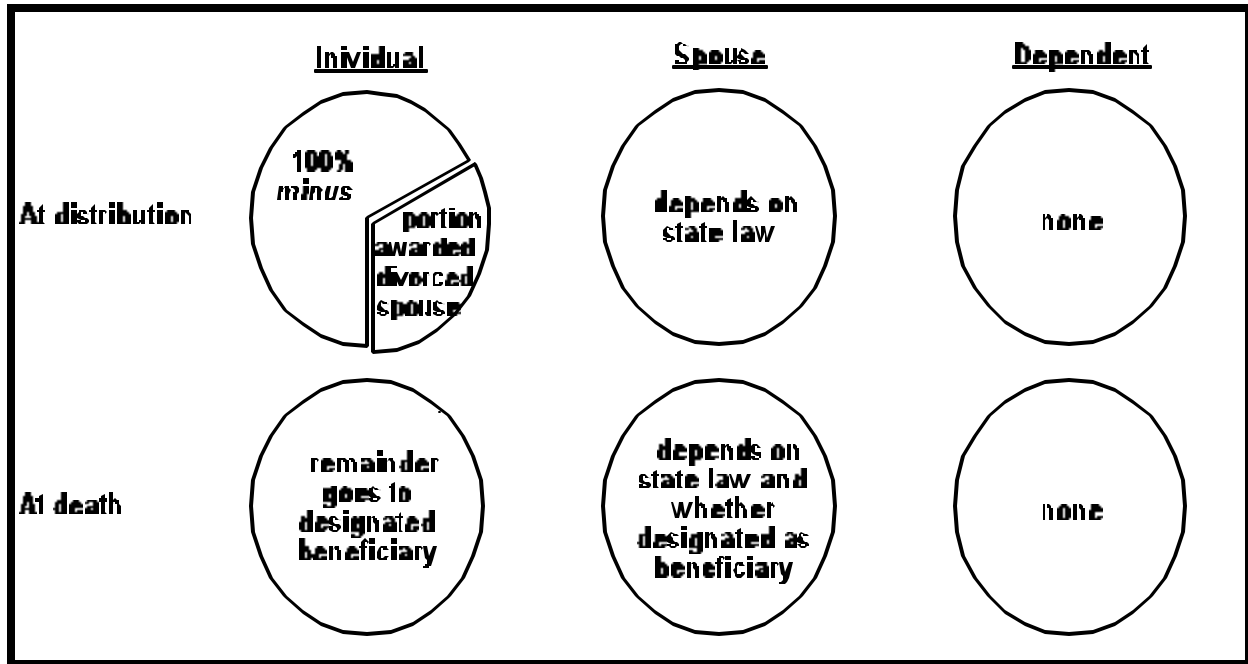


65). At retirement, the full benefit is calculated and then reduced, first for any portion allocated to a former spouse under a state court divorce order and second to pay for survivor benefits for the spouse. The individual receives payments for life. A spouse receives no payments, however, until the individual dies. At that time, payments equal to at least 50% of the deceased's benefit begin and continue for life. No benefits are payable to dependents or other descendants of the individual or the spouse, either during their lifetimes or at death.

Other defined contribution plans, such as profit-sharing or 401(k) plans, are not required to provide survivor annuities as long as the plan names the spouse as the death beneficiary of the other spouse's account and no annuity form of payment has been chosen. These plans, the most popular type of plan today, usually offer only lump sum distributions, although some will permit installment distributions over a period of five to ten years.¹⁷ Spouses have no control over when or how benefits are paid. A participant can take a loan or receive a distribution from these plans without spousal consent. Spousal death benefit protection applies only while funds remain in the plan. These plans are also required to honor a divorce decree awarding a portion of a participant's account to a former spouse. When a plan receives such an order, it usually transfers the amount awarded from the individual's account to a new account for the former spouse in the plan or to an IRA for the former spouse's benefit. In either case, the former spouse thereafter exercises all property rights, such as choosing investments and a form of payment, in the account.

IRAs : Although federal law determines how IRAs must be established and administered, it does not impose any system of marital property rights. From the federal perspective, individuals have sole rights to the assets in their IRAs. State law determines the rights of spouses, if any, to an IRA. Figure 4 illustrates

Figure 4. Marital Property Rights to IRAs



the marital rights that might apply to IRAs. At divorce, for example, assets in an IRA might be allocated between the spouses but that allocation would differ depending on whether common law or community property law applied.¹⁸ For example, under a community property system, the portion of the IRA attributable to the duration of the marriage would typically be divided between the spouses. The amount allocated would then be transferred to the other spouse, either directly or to an IRA established on his or her behalf. At death, state law would determine who inherits the IRA if no beneficiary has been designated.¹⁹ In a common law state, the IRA owner is generally free to name anyone as beneficiary but in a community property state a spouse has the right to designate a beneficiary for his or her share. There are no benefits for children or other dependents unless they are named as beneficiaries.

Enforcement of Property Rights:

Social Security, the private pension system and IRAs have very different enforcement systems for property rights. Table 3 briefly illustrates some of their major components.

Social Security: Social Security today has an enforcement system that relies almost entirely on federal law (McCormick 1998; West Group 1999). It provides an extensive administrative procedure for deciding disputes over benefits internally. Individuals begin the process by filing a claim for benefits with the Social Security Administration. If dissatisfied with an initial ruling, they are entitled to pursue a three-stage appeal or review procedure within the agency. If still dissatisfied after receiving a final determination, they may then turn to the federal courts for judicial review of an adverse ruling.²⁰ Individuals asserting a claim for Social Security benefits have the right to retain an attorney or other qualified agent to represent

them during the administrative proceedings. If the agency makes a favorable decision that an individual or a family member is entitled to retroactive benefits, it may also order that fees be withheld from the award and paid directly to the attorney (but not to any other representative). The fee amount which may be paid to a representative is limited by statute. A court which rules in favor of retroactive benefits may also order that attorneys fees, not to exceed 25% of the award, be paid from those benefits.²¹

Private Pension System: The private pension system also has an enforcement system based on federal laws - the tax code and ERISA. In addition, because a primary objective of ERISA is to provide uniform remedies for plan participants, any state law that “relates to” an employee benefit plan governed by ERISA is expressly preempted.²² Like Social Security, ERISA provides an administrative procedure for initial decisions about benefit claims. Each plan is required to have an internal set of procedures for ruling on the merits of claims.²³ Individuals whose claims have been denied may appeal that decision under those procedures. If the plan denies the claim on appeal, the individual can then pursue the claim in either federal or state court.²⁴ Unlike Social Security, ERISA has no express provision for paying attorneys fees from benefits.

IRAs: IRAs have no explicit enforcement system. Neither do they have any initial administrative procedure for settling disputes over claims for benefits. When a dispute arises over property rights to the account, the parties must pursue their claims under state law, at their own expense, through the court system.

Table 3. Enforcement Systems for Rights			
Attribute	Social Security	Private Pension System	IRAs
What law controls: In general At distribution At divorce At death	federal law federal law federal law not relevant	federal law federal law federal and state law federal law	state law state law state law state law
Who decides when there is a dispute:	federal agency initially, then claimants have appeal rights to courts	plan initially, then claimants have appeal rights to courts	courts
Who pays for attorneys fees:	claimants, fees limited to no more than 25% of retroactive benefits	claimants	parties

6. Building a Property Rights System for Individual Accounts under Social Security

It is a virtual certainty that property rights will accompany individual accounts if they are added to Social Security. These accounts, after all, will meet the test in *Nestor* that benefits be determined by contributions. In addition, they will undoubtedly be vested. It is clear from the experience of 401(k) plans that people feel strongly that *their* contributions are *their* money, and *they* alone should control how *their* accounts are managed and invested. Although Congress could decide to retain its authority to amend the program at will, including the power to terminate individual accounts and transfer those funds to the existing program, it is unlikely to do so. In the private pension system and IRAs, contributions made by individuals are always 100% vested, and there will be strong political pressure to provide similar protection to individual accounts in Social Security.

Individual accounts are popular largely because they provide individuals with more ownership rights, control and freedom of choice over their retirement savings than defined benefit-type plans. Those benefits, however, have their costs. In the case of Social Security, the primary cost is the system of family benefits that the program has historically provided. The pool of unallocated assets now used to provide automatic benefits to family members as well as individuals, and at no cost to them, does not exist in an individual accounts program. Instead, individuals and family members must compete for the available funds in the account.

Building a property rights system for individual accounts in Social Security will be a demanding task and involve difficult choices. At this point, it is only possible to suggest some guiding principles as well as some basic building blocks. The fundamental guiding principle is perhaps all too obvious. A system for Social Security should be built by adapting the best features of existing models whenever and to the maximum extent feasible. There is no single perfect property rights system for individual accounts, and Social Security should not attempt to create one. Retirement systems such as the private pension system and IRAs reviewed in this paper have valuable experience to contribute. These are the U.S. models which are most relevant for Social Security's purposes. But there are many other Social Security-type systems throughout the world, both created and revamped for individual accounts, from which some important lessons could be learned.

The second guiding principle is that a property rights system for individual accounts must find a balance between the retirement income needs of the individual and the legitimate support needs of other family members. This is the most central and material component of any property rights system for individual accounts. There is no absolute or universally right way to find that balance. As always, the central questions will concern the rights these accounts should have, who should have those rights, and when and how those rights should attach to benefits. There are a number of critical decisions to be made at the outset. Those decisions will then shape the remaining contours of the system. They include:

Whether, during the marriage, a spouse should have

- no rights over the account (*the IRA and common law approaches*)?
- some rights over the account (*the private pension system approach*)?
- equal rights over the account (*the community property approach*)?

Whether a divorced spouse should have

- rights to half the benefits earned during the marriage
(*the community property and earnings sharing approaches*)?
- benefits decided by a judge
(*the private pension system and common law approaches*)?

Whether the account should be inheritable by

- only the surviving spouse (*sometimes the private pension system approach*)?
- children of a deceased spouse (*sometimes the community property approach*)?
- anyone (*the IRA and common law approaches*)?

Whether income from the account should be available

- only at retirement (*the Social Security approach*)?
- before retirement but only for child support and alimony
(*the private pension system approach in some cases*)?
- before retirement for any reason at all (*the IRA approach*)?

Whether the account should pay retirement income

- with mandatory survivor benefits for a spouse
(*sometimes the private pension system approach*)?
- in any form the couple chooses together
(*also the private pension system approach*)?
- in any form (*the IRA approach*)?

The three final principles concern process rather than substance. This is a particularly important component for Social Security. Its individual account program will generate millions of accounts, a large proportion of which will be small in size. If these accounts are to produce the retirement income anticipated, the system for enforcing property rights must be efficient and economical. If it is not, account assets could be consumed by adversarial proceedings. Or the rights granted by the statute will be meaningless because they cannot be easily exercised by Social Security recipients. To achieve that goal, the following three strategies are suggested.

First, the statute authorizing individual accounts should be as comprehensive as possible. It should define as many important terms as possible. Such terms include who qualifies as a spouse, what form of divorce is valid; and who qualifies as a dependent. It should also carefully define how and when benefits may be paid from accounts. It should set standards for who is an eligible beneficiary of an account and

establish procedures for when no beneficiary has been named. The existing statute under Social Security already has many of these definitions, and it would be practical to apply them to individual accounts, when feasible as well. The intention here is to define the important concepts related to property rights with as much clarity and certainty as possible to minimize the potential for later disputes.

Second, it is important to provide some type of initial dispute resolution process which is relatively simple and inexpensive. Both Social Security and the private pension system provide an internal administrative process for this purpose. If individual accounts are administered by the Social Security Administration, its internal review system might be adapted for individual accounts. But if accounts are held instead in the private sector, it is unclear who should be the initial decision-maker and what type of process could be implemented. The banks, mutual fund families and insurance companies which are the most likely candidates to hold these assets are not likely to assume this responsibility willingly or for free. In addition, any dispute resolution process must be capable of relatively quick decisions. Claims should not be allowed to languish for months or years because these accounts will be exposed to market risk. For that reason, it is also important to clarify who holds investment powers in a disputed account and to prevent from intentionally harming the interests of other claimants to the account. The private pension system sets time limits for its administrative process, and similar limits could be applied to these accounts. As a last resort, the enforcement system could also include appeal rights to an IRA-type process which requires hiring attorneys and pursuing a claim in court. Few Social Security recipients, however, are likely to have the resources to exercise such rights. In addition, these accounts will be funded by relatively modest levels of contributions for many years to come and so will be too small to justify full-blown litigation. Moreover, the justice system is unlikely to welcome the addition of these claims to an already over-burdened court system.

Finally, it seems sensible to conclude that any property rights system for an individual accounts program should be primarily based on federal law. The IRA model seems particularly inappropriate for an individual accounts program under Social Security. Using a state law model would mean that property rights would vary depending on where individuals and family members lived. If they didn't live in the same state, difficult conflicts between the laws of several states would have to be resolved. People also move from state to state during their lives. This raises many issues concerning what law should apply to these accounts. For example, should contributions to the account be governed by the laws of each state from which they were made? Or should only the law of the current state of residence apply? A state law model seems to add unnecessary legal complexity and cost to a mandatory federal program intended to provide most Americans with their basic income in retirement.

The competing model from the private pension system expressly utilizes federal law to insure that plan beneficiaries have uniform rights and remedies. In addition, any state law that conflicts with the provisions of ERISA is preempted. This provides the private pension system with a simplified and consistent body of law that minimizes its administrative burden while efficiently protecting the rights of plan beneficiaries. Individual account plans are complicated. They require detailed record-keeping systems and special investment programs. If these accounts are added to Social Security, most Americans will have

such an account, and almost every family will depend on it for some form of income or support. The administrative burden on the Social Security Administration or any other entity authorized to maintain an individual accounts program in Social Security will be enormous. Basing its property rights system on a coherent and consistent set of federal laws is one of the few obvious ways to simplify such a program while providing adequate protection for the rights of Social Security recipients.

End Notes

1. This paper focuses on the legal elements of various property law systems, *not* their economic consequences or equitable considerations. Specifically, it does *not* examine how any particular system might affect the amount of Social Security benefits any particular individual might receive.
2. This paper provides a brief discussion of some general principles of law. More information about these principles can be obtained in the legal resources listed as references. The discussion in this paper is only intended to be an introduction to some of the legal concepts which will influence the design of a property rights system for Social Security. The legal issues to be resolved during that process will require the analysis of other forms of law such as case law, statutes and regulations. Such an analysis is beyond the scope of this paper.
3. Quoted in Turner 1994, pp. 129-130.
4. This discussion of marital property systems under state law is very abbreviated. It emphasizes the differences that exist between the two systems rather than their similarities. In reality, no state has a pure version of either system. Many states have blended community property and common law principles, primarily in the treatment of marital assets at divorce.
5. The traditional community property states, many of which adopted this system of law when they were French or Spanish colonies, are Arizona, Idaho, Nevada, Texas, Washington, California, Louisiana and New Mexico. Other states, such as Wisconsin, have adopted community property systems in modified form.
6. Some proposals are in the form of a floor-offset plan where the federal government will retain some rights to funds in these accounts. A floor-offset arrangement creates very difficult and extremely complicated property rights issues that are beyond the scope of this paper.
7. For purposes of this paper, “Social Security” means the federal old-age, survivors and disability insurance benefits program. It does not include the supplemental security income program.
8. These remarks, quoted by Justice Black in his dissenting opinion in *Flemming v. Nestor*, 363 U.S. 603 (1960) were made by Senator George, Chairman of the Senate Finance Committee when the Social Security Act was passed and can be found at 102 Congressional Record 15110.
9. The actual dispute in *Nestor* concerned the constitutionality of Section 202(n) of the Social Security Act, a provision added in 1954 which denies benefits to any alien deported on the grounds of illegal entry, conviction of a crime, or subversive activity under various sections of the Immigration and Naturalization Act. Mr. Nestor was a covered worker under Social Security from 1936 through 1955 when he began receiving benefits. He was deported in 1956 for having been a Communist Party member from 1936-1939. His Social Security benefits were then terminated, and he sued to have

them reinstated.

10. Since *Nestor*, Congress has exercised its power to alter and amend the program by reducing benefits retroactively. For example, the 1977 Amendments to the Social Security Act reduced benefits for people born after 1917.

11. For purposes of this discussion, the private pension system is defined to include qualified plans regulated by Internal Revenue Code § 401(a) and associated statutes as well as tax-deferred annuities regulated under Internal Revenue Code § 403(b). The rules discussed typically apply to plans sponsored by for-profit and not-for profit employers but not to plans sponsored by a state or local government entity. In general, the authorizing state statute establishes the rights of employees in governmental plans. Those rules differ from state to state and will not be discussed here.

12. A description of the various types of plans can be found in Pamela Perun and C. Eugene Steuerle. 2000. *ERISA At 50: A New Model for the Private Pension System*. The Retirement Project. Occasional Paper Number 4. Washington, D.C.: The Urban Institute.

13. Internal Revenue Code § 411(a) sets forth the vesting requirements for qualified plans and tax-deferred annuities. Employers can design their own vesting schedule, for example by providing for full vesting after 3 years, as long as their schedule is at least as generous as one of the statutory schedules. Employees are always 100% vested in their own contributions to a plan. Internal Revenue Code § 411(d)(6) protects vested benefits from employer cut-backs.

14. IRAs are authorized under Internal Revenue Code § 408. The discussion in this paper is limited to rules for individual IRAs rather than IRAs under an employer-sponsored plan such as a Simplified Employee Pension (SEP) or a Savings Incentive Match Plan for Employees (SIMPLE plan).

15. Internal Revenue Code §§ 401(a)(11), 401(a)(13) and 417.

16. The seminal case on this issue is *Boggs v. Boggs*, 520 U.S. 833 (1997) in which the Supreme Court held that, after REA, ERISA is intended to protect the economic security of surviving spouses. It ruled that a state community property law under which a predeceased spouse bequeathed her community property interest in her husband's pension benefits to her children conflicted with this express intent and was therefore preempted.

17. One reason for the increased popularity of these plans is that many employers prefer to avoid the administrative complications and possible fiduciary exposure that REA's survivor annuity requirements can entail.

18. The Tax Court has recently issued an opinion that, if upheld on appeal, would deny recognition of state community property law in IRAs. In a case of first impression, *Bunney v. Commissioner*, United States Tax Court, No. 20713-97 (April 10, 2000), the Tax Court held that IRAs funded with community funds were entirely taxable to the husband when transferred to his ex-wife. Among other

reasons, the Tax Court held that IRAs are intended to provide retirement income to an individual, not a couple, and that community property principles frustrate that purpose.

19. Under Internal Revenue Code § 401(a)(9), individuals are required to begin making withdrawals from their pension plans and IRAs when they attain age 70 ½. At that time, they must designate a beneficiary for purposes of calculating the required withdrawals, and that designation under federal law generally trumps any conflicting state law, at least for tax purposes.

20. Social Security Act § 205.

21. Social Security Act § 206.

22. ERISA § 514(a).

23. Standards for claims procedures can be found in ERISA § 503 and its regulations.

24. ERISA §§ 502(a)(1)(B) and 502(e)(1).

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