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The Retirement Systems Act

Richard H. Forster*

The recently enacted Retirement Systems Act, signed by the Governor June 25, 1945, and effective September 15, 1945, although accomplishing its major purpose of exempting most pension and profit-sharing plans from the jurisdiction of the Commissioner of Corporations comes as somewhat of a disappointment to persons interested in the field of employee benefit plans.

The act purports to put all "retirement systems" in existence on September 15, 1945, or thereafter created, under the jurisdiction of the Commissioner of Corporations by requiring that such systems secure a license from the Commissioner before "transacting any business." However, there are then specifically exempted from the requirements for qualification practically every type of employee benefit plan other than a wholly or partly uninsured pension or profit-sharing plan administered through a non-corporate trustee. There is no question as to the soundness of placing under regulation by the Commissioner of Corporations plans of this latter type. The objections to the act arise from its use of new and unfamiliar verbiage and its failure to cover adequately certain problems facing persons administering employee benefit plans of the types exempted from qualification under the act.

The revision by Congress in 1942 of Sections 22(b), 23(p), and 165(a) of the Internal Revenue Code made extensive and radical changes in the method of taxation of contributions into pension and profit-sharing plans for the benefit of employees, the method of taxation of the income of a trust forming part of such a plan, and the method of taxation of the benefits received by the employees under the plan. Complicated regulations have been worked out by the Commissioner of Internal Revenue relating to these sections. The California income and franchise tax acts and the regulations thereunder have been amended by adoption of the federal act and regulations.

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1 Cal. Stats. 1945, c. 1035.
practically word for word. Hundreds of employee benefit plans have been put into effect by employers in California, and practically all of them have had to satisfy the requirements of these acts and regulations.

The primary reason for the enactment of the Retirement Systems Act was to cure the confusion resulting from an Attorney General's opinion dated November 30, 1944, to the effect that the creation of a non-contributory, trusteed pension plan for the benefit of employees constituted the issuance of a security under the California Corporate Securities Act. Two other serious problems in connection with employee benefit plans, the taxation of the funds under state property taxes and the possibility of a trust used in conjunction with a plan violating the rule against perpetuities or the rule against restraints on alienation, were sought to be cured by the enactment of the Retirement Systems Act. Unfortunately, neither of these last two problems has been eliminated.

Section 2 of the Retirement Systems Act authorizes employers

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2 The sections of the Federal Act and Regulations appear in the following provisions of the California Income and Franchise Tax Acts and Regulations thereunder:

<table>
<thead>
<tr>
<th>FEDERAL</th>
<th>CALIFORNIA</th>
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<tbody>
<tr>
<td>I. R. C. 165(a)</td>
<td>REV. &amp; TAX. CODE, §§18156 to 18102 incl.</td>
</tr>
<tr>
<td>Reg. 111, 29.165-1 to -4</td>
<td>Reg. Art. 12(f) to 12(f)-5 incl.</td>
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<tr>
<td>I. R. C. 22(b)(2)(B)</td>
<td>REV. &amp; TAX. CODE, §§17125.5 and 17125.7 incl.</td>
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<tr>
<td>Reg. 111, 29.22(b)(2)-5</td>
<td>Reg. Art. 7(b)(2)-5.</td>
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<tr>
<td>I. R. C. 23(p)</td>
<td>REV. &amp; TAX. CODE, §§17324 to 17324.16 incl.</td>
</tr>
<tr>
<td>Reg. 111, 29.23(p) -1 to -8</td>
<td>Reg. Art. 8(m)-1 to -12 incl.</td>
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3 Employers exempt from income tax have still had to qualify their plans under 165(a) in order to prevent the income of the trust from being taxed, in order to prevent the distributions into the plan from being immediately taxable income to the employees, and in order to keep from violating wage and salary stabilization laws.

4 Practically all such trusts created in California have had to contain a provision to the effect that the trust will terminate upon the death of the last survivor of the original participants in the plan, in order to prevent the possibility of violating the provisions of CAL. CIV. CODE (1943) §715. This wholly artificial termination date is inconsistent with the purpose of such a plan. Several states have already adopted legislation exempting employee benefit plans from the rule against perpetuities and the rules against accumulation and/or suspension of the power of alienation. See Ala. Gen. Ass. 1945, Act No. 306; Dela. Laws 1945, c. ..., Ill. Laws 1945, S.B. 425; ILL. REV. STAT. ANN. (Smith-Hurd) c. 30 §154, as amended by Laws 1945 S.B. 426; Mo. REV. STAT. §3541-B; N. Y. PERSONAL PROPERTY LAW §13-C, 16; N. C. GEN. STATS., c. 36, §36-5.1; R. I., Pub. L. 1943, c. 1346.
and employees to "form or create a trust or trust fund hereinafter referred to as a 'retirement system' for the purpose of providing benefits on account of members retiring by reason of age or length of service or both," upon filing certain documents with the Commissioner of Corporations.  

Section 3 provides that a retirement system may supplement the above retirement benefits by providing benefits on account of disability or death and may provide withdrawal equities. Section 8 provides that the property of a retirement system, the portion of wages or salary of the employee deducted or to be deducted, the right of an employee to a pension benefit, and all his rights in the funds of the system, shall be "exempt from taxation" and from the operation of any law relating to bankruptcy or insolvency. Section 9 provides that no trust forming part of a retirement system shall violate the rule against perpetuities or the rule against suspension of the power of alienation and that income may be accumulated until the fund is sufficient to accomplish the purposes of the trust.

Section 24 provides that "A beneficial interest issued by a retirement system as defined in this act shall be exempt from the provisions of the Corporate Securities Act." Section 25 exempts certain retirement systems established by governmental entities and the University of California "from the provisions of this act, other than Section 24." Section 26 provides that "The provisions of this act, other than Section 24, shall not apply to a retirement system in which all contributions" are paid to an insurance company authorized to do business in California and all benefits are paid directly by the insurance company to the employees or their beneficiaries. Section 27 provides that "The provisions of this act, other than Section 24, shall not apply to a retirement system" under which all funds are paid to a trustee subject to the control of the Superintendent of Banks, or the Controller of Currency or to a trustee which is a bank and a member of

Although the act constantly refers to a retirement system "as herein defined," there is actually no definition of a retirement system in the act other than as it can be implied from the above quotation. This language is very confusing since it states that the trust is a retirement system. The majority of the employee benefit plans which have been adopted set forth the terms of the plan in one instrument. The funds contributed pursuant to the terms of the plan are then turned over to a trustee under a trust which contains only provisions relating to the handling of the trust fund. The administration of the plan is governed by its terms and generally handled by a pension or advisory committee wholly independent of the trust or the trustee. Throughout the act, there is provision made for regulation of "retirement systems" which can have no meaning unless the "system" is intended to mean the plan pursuant to which a trust has been created.
the Federal Reserve Bank. Section 28 provides that "The provisions of this act, other than Section 24, shall not apply" to a retirement system set up for the employees of a public utility or common carrier, and Section 29 provides that "The provisions of the act, other than Section 24, shall not apply to any retirement system established for employees of a foreign corporation not doing an intrastate business in this State."

The first problem arises from the adoption of a new definition for employee benefit plans under Section 2 of the act. Since practically all employee benefit plans must qualify under Section 165(a) of the Internal Revenue Code and since all persons interested in such plans are familiar with the provisions of this section, it would seem that the Retirement Systems Act should have been more closely tied in to the provisions of Section 165(a) and the corresponding provisions of the California Franchise Tax Act.

Employee benefit plans involving the use of a trust fall into two major groups. They are either pension plans or profit-sharing plans. Both types ordinarily provide benefits "on account of members retiring by reason of age or length of service or both," and both types generally provide benefits on account of disability or death and termination of service. The only difference in principle between a pension and most profit-sharing plans is that in the former the benefits at retirement are fixed and the contributions into the plan are then determined actuarially in order to provide sufficient funds to pay the benefits at retirement, while under a profit-sharing plan, the retirement benefits are not fixed since the amount accumulated to the account of each employee will depend primarily on the continued ability of the employer to make contributions out of its profits.

There would seem to be no question but what trusts forming a

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6 Confusion arises from the language of Section 27 to the effect that the provisions of the act shall not apply to "a retirement system which provides that all funds contributed shall be paid to a trustee," etc. Assuming that the words "retirement system" are used in a broad sense of including both the trust and the plan, these words would seem to imply that the plan must expressly provide by its terms that funds can only be paid to a trustee of the type described in Section 27. By this reasoning any plan which authorizes the appointment of individual trustees or does not expressly limit the potential trustee who could serve to one of the type described in Section 27 would not be exempt from the provisions of the Retirement Systems Act under Section 27 and would have to qualify. Since there are almost no plans which expressly make provision in the exact language set forth in Section 27, if this reasoning is correct, practically all plans will have to qualify even though it is clearly the intent that they be exempted so long as the funds are actually paid to a trustee of the type described in Section 27.
part of both of these types of plans fit the definition of a "retirement system" contained in Section 2 of the Retirement Systems Act. Certainly both types of plans should be treated the same in so far as jurisdiction of the Commissioner of Corporations is concerned. However, certain sections of the act seem to imply that the only type of plan which the draftsmen had in mind was the true pension plan. For example, Section 7 provides that a retirement system subject to the provisions of the act, except to the extent that its benefits are underwritten by an insurance company, must create and maintain reserves calculated to be adequate to cover the liabilities on account of benefits payable to the employees. The Commissioner is authorized to examine the method on which the reserves are set up. This language seems to overlook entirely the fact that a retirement system, as defined in the act, includes most profit-sharing plans and that under the terms of any profit-sharing plan the benefits payable at retirement are indeterminable.

One class of employee benefit plans which qualifies for tax purposes as such but is clearly not covered under the Retirement Systems Act is a plan providing for accumulation of contributions by the employer to a trust for the benefit of employees until the expiration of a fixed number of years from the date of adoption, at which time distribution will be made to the employees. Several plans of this type have been adopted. There seems to be no sound reason why these plans, other than those defined in Sections 25, 26, 27, 28, and 29, should not be regulated by the Commissioner of Corporations in the same way as a plan providing for benefits at retirement.

The wording of Sections 25, 26, 27, 28, and 29 is such that no provisions of the Retirement Systems Act, other than Section 24, apply to any retirement system of the types described in these sections.

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7 The necessity for such control by the Commissioner of Corporations is questionable. The Commissioner of Internal Revenue, before approving a pension plan under 165(a), will insist that proper actuarial assumptions have been used. Furthermore, any company large enough to consider the adoption of an uninsured pension plan will be forced to set up adequate reserves purely as a matter of maintaining satisfactory employee relations. However, the matter is of little significance since the possibility is remote of a company adopting a pension plan subject to the provisions of section 7 with a non-corporate trustee—and if there is a corporate trustee, the provisions of section 7 are not applicable to the system.

8 Such plans may still be subject to the provisions of the Corporate Securities Act and therefore under the jurisdiction of the Commissioner of Corporations, whether or not a corporate trustee is used. However, it would seem more advisable to treat them in the same manner as other employee benefit plans.
The only type of plan which would fit the definition of "retirement system" and still not be exempted from the effect of the act by these sections is one in which a non-corporate trustee is used and the trustee is given authority to invest all or any part of the trust funds other than in contracts issued by a life insurance company. There are very few profit-sharing or uninsured pension plans in which individual trustees are appointed in lieu of a corporate trustee.

Although the cost and legal procedure involved in securing a license from the Commissioner of Corporations for a retirement system not exempted from the effect of the act are both of little significance, nonetheless the authority and duties granted to the Commissioner of Corporations to examine the books and records of such a system would seem to indicate that in the case of any employee benefit plan in which an individual trustee has been used, it would be well to consider the advisability of substituting a duly qualified corporate trustee.\(^9\)

On the other hand, the failure of the draftsmen of the Retirement Systems Act to include the words "other than Sections 8 and 9" in Sections 25 through 29 results in emasculating the effect of the otherwise commendable provisions of these two sections. In other words, although practically all pension and profit-sharing plans are now clearly taken out of the jurisdiction of the Commissioner of Corporations, nevertheless they still may violate the rule against perpetuities and the rule against suspension of the power of alienation unless proper provisions are inserted in the trusts, and the properties of the trusts will be subject to taxation.\(^10\)

Although the question is of little significance since, as has been pointed out, Section 8 applies to very few trusts, nevertheless the provision in this section that the property of such a trust and all rights of an employee in the trust shall be exempt from the operation of any law relating to bankruptcy is open to serious question as to its

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\(^9\) §§10, 11, 12, 13, 14, 15, and 15.1 grant to the Commissioner of Corporations broad powers to examine the books and records of a retirement system and its "business and affairs," all at the expense of the system. He is given authority, in the event he feels that the system "is conducting business in an unsafe manner or is unable to fulfill the benefits granted in said system," to order the system to cease operations and to liquidate, or the Commissioner may take possession of the business and the assets for the protection of the beneficiaries. In the latter event, the Commissioner is given authority to continue the operation of the system, etc.

\(^10\) The words "exempt from taxation" in Section 8 apparently refer only to property taxes, although it would clarify the meaning if this delineation were spelled out.
efficacy. The Federal Bankruptcy Act provides for exemption of property exempt from the laws of execution of each of the states.\textsuperscript{11} It would not seem possible for the State of California to exempt property from any law relating to bankruptcy except by including such property in the statutes exempting property from execution.

It would seem advisable that immediate legislation be enacted amending the provisions of the Retirement Systems Act in at least the following particulars:

1. The language of the act should be rewritten so as to include any trust satisfying the requirements of section 165(a) of the Internal Revenue Code.
2. Section 8 should be rewritten so as to clarify the meaning of "exempt from taxation" and "exempt from the operation of any law relating to bankruptcy."
3. Sections 25 through 29 should provide that the provisions of Section 8 and Section 9 still apply to trusts of the types described in these sections.
4. Section 27 should be amended to provide that the provisions of the act shall not apply to a retirement system under which funds are paid to a trustee of the type described in that section, in lieu of the present language which implies that the instrument itself must expressly prohibit payment to any trustee other than of the type described in that section.
5. The language of the act should be made more applicable to the actual operation of employee benefit plans. For example, Section 4 states that "a retirement system shall have trustees, agents, or officers who shall carry on the business of the system." The system has been defined as a trust or trust fund. It is difficult to understand how a trustee carries on a business by holding securities and investing them, especially if the investment is done only in accordance with directions of a pension or advisory committee. Sections 14, 15, and 20 use the same language. Perhaps the "business" referred to is the operation of the plan, rather than the trust.

The use in Section 4 of the word "shall" with the plural words "trustees, agents, or officers" would seem to make it mandatory to have more than one trustee. Certainly it is difficult to conceive of the trust having officers or agents as such.\textsuperscript{12}

\textsuperscript{12} The word "shall" is also used in Section 30 which provides that "A license under this act shall be issued, without payment of any fee, to any retirement or pension plan
APPENDIX

CHAPTER 1035

An act to provide for the establishment of retirement systems for the purpose of creating benefits on account of members retiring by reason of age, length of service, disability or death, providing for licensing and supervision by the Commissioner of Corporations.

The people of the State of California do enact as follows:

SEC. 1. This act shall be known as "The Retirement Systems Act."

SEC. 2. The employees, officers and agents of any person, firm or corporation or of one or more corporations having business interests in common, hereinafter referred to as the "employer," or such employees and employer jointly, may form or create a trust or trust fund hereinafter referred to as a "retirement system," for the purpose of providing benefits on account of members retiring by reason of age or length of service or both, by filing in the office of the Commissioner of Corporations a declaration of their intention so to do, in a form approved by the Commissioner of Corporations, signed and acknowledged by two provisional trustees or officers of such system, accompanied by a duly authenticated copy of the constitution, by-laws or declaration of trust adopted to regulate the affairs of the system. Upon the filing of such declaration and duly authenticated copy, the Commissioner of Corporations may, if satisfied that the plan of operation is sound and equitable, issue a license authorizing the retirement system to do the business described therein.

SEC. 3. A retirement system may supplement the above retirement benefits by providing benefits on account of disability or death and may provide withdrawal equities.

SEC. 4. A retirement system shall have trustees, agents, or officers who shall carry on the business of the system. The by-laws or declaration of trust of such a system shall prescribe the manner in which and the officers or agents by whom the system may be conducted and the manner in which its funds shall be collected and disbursed. The funds and investments of a retirement system shall be held separately and independently of the funds and investments of the employer and of any other person or persons.

SEC. 5. The participating employees, or the employer, or both, may contribute to the funds of the retirement system and the contributions shall be adequate to support the benefits granted. All or any part of the pension benefits may be underwritten by an insurance company authorized to insure such risks in this State, as may be provided for in the by-laws or declaration of trust of the retirement system.

SEC. 6. A retirement system organized or created under the provisions of this article shall not issue or deliver any certificate or contract providing for or promising to pay any benefit until a copy of the form thereof has been filed with the Commissioner of Corporations and not disapproved by him.

SEC. 7. A retirement system subject to the provisions of this act shall, except to the extent that its benefits are underwritten by an insurance company authorized to transact such business in this State, create and maintain reserves, calculated to be adequate to cover the liabilities on account of benefits payable under its contracts, by-laws or declaration of trust. The commissioner may require such results to be calculated on the basis of an interest rate not in excess of 4 per cent per annum and mortality, disability and other experience tables based on reliable experience for such or a similar group of employees and approved by the Commissioner of Corporations.

heretofore filed with the Commissioner under the provisions of the Corporate Securities Act and to which a permit has been issued authorizing the sale and issuance of securities." This would seem to imply that the Commissioner must automatically issue a license without any application being made under the Retirement Systems Act, to any retirement or pension plan to which a permit has been issued. This is the only time in the act in which the word "pension" is used, and since "retirement" is used alone without referring to a retirement system as defined in Section 2, there arises an additional uncertainty as to what plans are covered under the provisions of Section 30.
SEC. 8. The property of a retirement system, the portion of wages or salary of an employee deducted or to be deducted, the right of an employee to a pension benefit, and all his rights in the funds of the system, shall be exempt from taxation and from the operation of any law relating to bankruptcy or insolvency.

SEC. 9. No trust forming part of a retirement system shall be deemed invalid as violating any existing laws against perpetuities or suspension of the power of alienation of title to property; and the income arising from any property, real or personal, held in such trust may be permitted to accumulate until the fund shall be sufficient, in the opinion of the trustee or trustees thereof, to accomplish the purposes of such trust.

SEC. 10. The Commissioner of Corporations whenever he deems necessary shall examine the business and affairs of a retirement system.

SEC. 11. Every retirement system examined under the provisions of this act shall open its books and papers for the inspection of the Commissioner of Corporations and otherwise facilitate such examination.

SEC. 12. The Commissioner of Corporations may administer oaths and examine under oath any person relative to the business of a retirement system.

SEC. 13. An examination of a retirement system shall be at the expense of the retirement system. If a retirement system shall refuse or neglect to pay such expense of examination within 30 days after mailing of invoice therefor, the Commissioner of Corporations may refuse to issue a licence to such a system or may revoke any existing license.

SEC. 14. In the event the Commissioner of Corporations determines after such an examination that a retirement system is conducting business in an unsafe manner or is unable to fulfill the benefits granted in said system he may order such retirement system to cease operations and to liquidate or he may take possession of the business and assets for the protection of the beneficiaries of the retirement system.

SEC. 15. On taking possession of the business and assets of a retirement system the Commissioner of Corporations may continue the operation of the system, may return the business and assets to the retirement system or may finally liquidate its business and affairs. In the event the Commissioner of Corporations continues to operate the system he may take any action necessary to enforce the provisions of the trust or he may, where the parties to the trust have fulfilled their obligations, modify the benefits granted in said system in accordance with the financial condition of the trust.

SEC. 15.1. Whenever any retirement system of whose property, business and assets the commissioner has taken possession, as aforesaid, deems itself aggrieved thereby, it may at any time within 30 days after such taking possession apply to the superior court of the county in which the principal office of such retirement system is located, to enjoin further proceedings and said court after citing the commissioner to show cause why further proceedings should not be enjoined, and hearing the allegations and proofs of the parties and determining the facts, may upon the merits dismiss such application or enjoin the commissioner from further proceedings and direct him to surrender such business, property and assets to such retirement system. An appeal from such judgment enjoining the commissioner from further proceedings and directing him to surrender such business, property and assets to such retirement system shall not operate as a stay thereof, unless the trial court in its discretion, shall so order and no bond need be given if such appeal be taken by the commissioner; but if such judgment dismisses such application an appeal therefrom shall not operate as a stay thereof but the court rendering such judgment may, in its discretion, enjoin the commissioner, pending the appeal, from further proceedings and direct him, pending the appeal, to surrender such business, property and assets to such retirement system, provided a bond shall be given as required by Section 943 of the Code of Civil Procedure.

SEC. 16. Any order, decision or other action of the Commissioner of Corporations in the administration of this act shall be subject to review in accordance with law.

SEC. 17. A fee of fifty dollars ($50) shall be paid to the Commissioner of Corporations on the filing of the declaration provided for in Section 2.

SEC. 18. All fees collected by the Commissioner of Corporations under the provisions of this act shall be paid into the State treasury to the benefit of the General Fund.
Sec. 19. The Commissioner of Corporations may maintain and prosecute an action against any retirement system, its officers, directors, trustees or agents or against any other person or persons subject to the provisions of this act, for the purpose of obtaining an injunction restraining such person or persons from doing any act in violation of the provisions of this act.

Sec. 20. No retirement system heretofore or hereafter created pursuant to the laws of the State of California shall transact business without first securing a license so to do from the Commissioner of Corporations.

Sec. 21. Any person, firm, company or corporation who violates any of the provisions of this act shall be guilty of a misdemeanor.

Sec. 22. The Commissioner of Corporations is hereby authorized and empowered to make such rules and regulations as may be necessary to carry out the purposes and intent of this act.

Sec. 23. The Attorney General shall be counsel for the Commissioner of Corporations and shall render all legal services necessary for the administration of this act.

Sec. 24. A beneficial interest issued by a retirement system as defined in this act shall be exempt from the provisions of the Corporate Securities Act.

Sec. 25. A retirement system established by the Government of the United States, or by any territory or insular possession thereof, or by the State of California or any county, city and county, city, municipal corporation, school or public district or by any group of employees thereof, and the pension and retiring annuities system heretofore established by The Regents of the University of California, shall be exempt from the provisions of this act, other than Section 24.

Sec. 26. The provisions of this act, other than Section 24, shall not apply to a retirement system in which all contributions by the employer or employee or both are paid, either directly or through a trustee, to an insurance company authorized to do business in the State of California, and all benefits are paid directly by the insurance company to the employee or his beneficiaries.

Sec. 27. The provisions of this act, other than Section 24, shall not apply to a retirement system which provides that all funds contributed shall be paid to a trustee or co-trustee qualified and doing business in the State of California, subject to the supervision of the Superintendent of Banks or the Controller of the Currency, or that such funds shall be paid to a trustee or co-trustee that is a bank and a member of a Federal Reserve Bank.

Sec. 28. The provisions of this act, other than Section 24, shall not apply to any retirement system established for employees of any public utility or common carrier, as defined in the Public Utilities Act of this State, or the Interstate Commerce Acts, Federal Communication Act or Federal Power Act.

Sec. 29. The provisions of this act, other than Section 24, shall not apply to any retirement system established for employees of a foreign corporation not doing an intrastate business in this State.

Sec. 30. A license under this act shall be issued, without payment of any fee, to any retirement or pension plan heretofore filed with the commissioner under the provisions of the Corporate Securities Act and to which a permit has been issued authorizing the sale and issuance of securities.

Sec. 31. If any clause, section, sentence, provision or part of this act shall be adjudged to be unconstitutional or invalid for any reason by any court of competent jurisdiction, such judgment shall not impair, affect or invalidate the remainder of this act, which shall remain in full force and effect thereafter.