#39.60 2/26/71

Memorandum 71-11

Subject: Study 39.60 - Attachment, Garnishment, Exemption From Execution (Retirement Funds)


Summary

At least until last year, private employees in California have been denied the exemption from execution, attachment, and garnishment of pension, retirement, disability, and death benefits that has, for some time, been granted to public employees in California. 1970 legislation (Code Civ. Proc. § 690.18; Cal. Stats. 1970, Ch. 1523) arguably contains an exemption for some private employee benefits but does not place private and public employees on a parity in this regard. This memorandum discusses revision of the exemption provisions to bring into conformity the exemptions for public and private employee benefits.

Public employees are presently granted an automatic exemption for undistributed benefits and may claim an exemption for benefits distributed to them. The automatic exemption also applies to vacation credits. At the most, Code of Civil Procedure Section 690.18 affords private employee benefits an exemption from execution, attachment, and garnishment which must be claimed in all cases and which does not apply to vacation credits. At the least, the private employee exemption contained in Section 690.18 applies only in cases of bankruptcy and does not apply to attachment and garnishment at all. In either case, benefits of self-employed persons and their employees under the Keogh Act are specifically excluded from Section 690.18. Keogh Act benefits plans do present a problem not encountered with benefit plans for state

employees in that voluntary contributions may be made to Keogh Act plans which, if Keogh Act plans were exempt, might be used to sequester funds in anticipation of execution, attachment, or garnishment.

Conforming exemptions for public and private employee benefits thus raises the following questions:

(1) Assuming that private employee benefits should be (or have been) made exempt from execution, attachment, and garnishment generally, whether the exemption should not be made automatic at least with respect to undistributed or accumulated benefits;

(2) Whether Keogh Act benefit plans ought to be made exempt; whether sufficient safeguards can be drafted which prevent abuses to creditor's rights while providing exemption protection to self-employed persons and their employees;

(3) Whether vacation credits of private employees ought to be made exempt to the same extent as are vacation credits of public employees. This question involves two subquestions: (a) whether an exemption ought to be extended to vacation credits when they are paid out during the period of a leave of absence of upon departing service or whether, in such cases, funds representing vacation credits should be treated as are other earnings; (b) whether, supposing an exemption is extended to paid out vacation credits, it should not be an exemption required to be claimed under Code of Civil Procedure Section 690.50.

## Analysis

1970 amendment to benefit exemption provisions. In general, the 1970 legislation (Code Civ. Proc. § 690.18; Cal. Stats. 1970, Ch. 1523) combines two former provisions for exemption of public employee benefits, reenacts a third former provision for public employee benefits, and adds a provision for private employee benefits. Section 690.18(a) is, in substance, former Section 690.22, permitting an exemption to be claimed for money distributed to a public employee from a benefit plan. Section 690.18(b) is the same as former Section 690.23, exempting moneys held in or in process of distribution by a benefit plan for public employees, with three notable changes and additions: undistributed public employee benefits are now automatically exempt without claim for exemption; the exemption is clarified and perhaps amplified by making it apply to "rights and benefits accrued or accruing" to public employees as well as to undistributed moneys; the provisions of former Section 690.12 are added and reenacted so as to extend the automatic exemption to public employee "vacation credits." Section 690.18(c) appears to be a flawed attempt to grant private employee benefits, distributed and undistributed (and excluding Keogh Act plan benefits and private employee vacation credits), the same exemption as Section 690.18(a) provides distributed public employee benefits.

Extent of the new exemption for private employee benefits. Section 690.18(c) makes money still in possession of a private plan (but not "all rights and benefits accrued or accruing" in such a plan) and money distributed from such a plan to a private employee "exempt from execution, attachment, or garnishment in any bankruptcy proceeding." The quoted language would seem to indicate unresolved cross-purposes in the enactment of Section 690.18(c). Attachment and garnishment are statutory procedures distinct from discharge in bankruptcy, and, of course, assets in process of distribution in bankruptcy are not subject to attachment and garnishment. The language may mean (ignoring "in any bankruptcy proceeding") that some private employee benefits are granted the same exemption from execution, attachment, and garnishment as Section 690.18(a) grants distributed public employee benefits. Alternatively, Section 690.18(c) may be read (ignoring "execution, attachment, or garnishment") as invoking Section 6 of the Bankruptcy Act (11 U.S.C.A. § 24), which specifically adopts state exemptions from bankruptcy. As it stands, Section 690.18(c) provides private employee benefits an exemption the extent of which can only be guessed at.

Exemption of vacation credits. The use of the term "vacation credits" in Section 690.18(b) and its predecessors (former Sections 690.12, enacted 1968, and 690.125, enacted 1969) suggests that the term means there what it means in statutes defining vacation credits of state employees and that methods of indirect compensation inconsistent with the latter meaning are not intended to be exempted by Section 690.18(b). Vacation credits of state employees are computed as portions of daily pay due in excess of what is due for days actually worked in a given period. See Government Code Section 18050. Such excess pay becomes payable when the employee takes a vacation or when he leaves state service and at no other time. Accumulation of credits is restricted; beyond prescribed levels, credits lapse if service continues and no vacation is taken.

Vacation credits in the context of Section 690.18(b) thus appear to be most properly characterized as a sort of limited, deferred compensation: limited in that accumulations are restricted and deferred in that credits become payable only upon taking a vacation or departing service. So viewed, vacation credits are substantially similar to employee contributions to pension, retirement, death, and disability plans and would appear, at least in some cases, to serve the same purpose.

Section 690.18(b) provides an automatic exemption for vacation credits "accumulated by" a public employee. Section 690.18(a), dealing with distributed benefits, does not mention vacation credits. It thus appears that Section 690.18 does not intend an exemption for paid out vacation credits, but, rather intends that vacation credits, once paid out, be treated as earnings subject to execution under other rules. Any exemption for paid out vacation credits would derive from Section 690.18(b) and would be automatic. The result would be to throw upon creditors the burden of proof of the source of moneys sought to be attached or garnished and claimed to be paid out vacation credits; generally, it appears that such burdens are intended by Section 690.18 to be placed upon debtors.

As noted, however, Section 690.18 views vacation credits as it does employer contributions to benefit plans, and it may be pointed out as a matter of raising a question of policy that to extend an exemption to vacation credits when paid out would not be inconsistent with the general scheme of Section 690.18 to make other benefits exempt when in process of distribution from a fund and when received by the beneficiary. Vacation credits paid out at the time of retirement may be viewed as a supplement to retirement benefits, and vacation credits are not infrequently drawn upon in lieu of or as a supplement to sick leave pay, in which case they may be viewed as supplementary to disability benefits. An exemption of paid out vacation credits, however, raises the problem noted above of allocating the burden of proof as to source of moneys sought to be attached or garnished; any exemption of paid out credits should be required to be claimed.

Exemption of Keogh Act plan benefits. Ostensibly, the reason for excluding Keogh Act plans from amended Section 690.18 was a fear that excepting such plans from execution in bankruptcy, or from execution, attachment, and garnishment, would permit the sequestering of funds by making voluntary contributions to a plan in anticipation of execution. An examination of the conditions for qualifying a retirement or pension plan under the Keogh Act should indicate that total exclusion of such plans from exemption for execution is not necessary. The following is a brief discussion of the prerequisites of Keogh Act plans. Attached as Exhibit I (pink) is a more detailed discussion, based chiefly upon Carter, Self-Employed Retirement Plans (Cal. Cont. Ed. Bar 1968).

To be qualified for preferential tax treatment, Keogh Act plans must require employer contributions on behalf of employees at regular intervals and at least in specified minimum amounts. As a practical matter, employer contributions for any one employee are never likely to exceed $2,500 in any year and are likely, in the majority of cases, to be considerably less. Thus, exemption of employer contributions to Keogh Act plans goes no further than exempting employer contributions to public employee plans. The Keogh Act, however, also permits voluntary contributions to a plan by an employee on his own behalf. Such voluntary contributions are restricted in numerous ways but might, nevertheless, provide a means of sequestering funds in anticipation of bankruptcy if Keogh Act plan funds were to be exempt from execution, attachment, and garnishment. Such abuses, however, might be prevented by the relatively simple measure of denying exemption to voluntary contributions made within a specified time of issuance of a writ of attachment or thereafter until the levy is paid. In a minority of cases, a self-employed individual may have sufficient authority in a business as to be able to control employer contributions on his behalf to a Keogh Act plan, or distributions on his behalf from a plan, so as to protect himself from creditors if Keogh Act plans were exempt. The federal law proscribes such irregular employer contributions and distributions, but the penalties are only loss of favored tax status. Thus, if Keogh Act plans are to be exempt from execution, attachment, and garnishment, it would be appropriate to complete protection against abuses of creditors' rights to provide that exemption will be denied not only voluntary contributions under some conditions but also, under the same conditions, employer contributions and distributions from a plan where they are in violation of the terms of a plan or of the federal law.

Conclusions

There appears to be no good reason for denying to pension, retirement, disability, and death benefit plans for private employees--including Keogh Act plans--substantially the same exemption from execution, attachment, and garnishment provided such plans for public employees. Existing provisions appear to grant a confused and incomplete exemption to private plans, excluding Keogh Act plans. Possibly, the present exemption for private plans applies only in cases of bankruptcy.

If the exemption provisions for public and private plans are to be brought into conformity, the following steps should be taken:

1. Code of Civil Procedure Section 690.18 should be amended to delete subdivision (c). Subdivision (c) should be replaced with a new Section 690.185 granting the same exemptions to private employee pension, retirement, disability, and death benefit plans as is granted such plans for public employees by subdivisions (a) and (b) of Section 690.18. The exemption for distributed private employee benefits should be required to be claimed; the exemption should be automatic for undistributed benefits.

2. New Section 690.185 should contain a subdivision defining vacation credits for private pemployees in substantial conformity with Government

Code Section 18050. Vacation credits of private employees, as defined, should be granted an automatic exemption so long as they are accumulated and not paid out. Provision may also be made for claimed exemption of paid out private employee vacation credits as defined.

3. New Section 690.185 should contain a subdivision negating any exemption for moneys which are voluntary contributions to Keogh Act plans made within 30 days of issuance of a writ of execution or thereafter until the levy is paid or which are contributions to or distributions from a Keogh Act plan made during the pendency of an attachment and in violation of the provisions of the plan or of the federal law.

Attached as Exhibit II (yellow) are an amended Section 690.18 and a new Section 690.185. New Section 690.185 provides a claimed exemption for paid out vacation credits of private employees, which provision has been written so as to be readily deleted if it is the concensus of the Commission that paid out vacation credits should not be exempt.

Respectfully submitted,

E. Craig Smay
Legal Counsel

Memorandum 71-11

EXHIBIT I

Keogh Act Plans

The Keogh Act prescribes standards for federal income taxation of contributions to and distributions from pension and retirement plans set up by self-employed individuals for themselves, their employees, or both. The salient questions under the act are: (1) When will a deduction be granted for contributions to a retirement or pension plan? (2) What will be the tax treatment of contributions once made? (3) What will be the tax treatment of a distribution from a plan? The answers to those questions depend largely on the employment status of individuals involved. The act classifies three types of employees: owner-employees, partner-employees, and employees in the common law sense. Owner-employees are at least partners who own greater than a 10% capital or profit interest in the business. Int. Rev. Code of 1954, § 401(c)(3). Partner-employees are partners whose capital or profit interest is 10% or less. The restrictions of the act are more stringent with regard to owner-employees than with regard to partner-employees, and more stringent with regard to partner-employees than with regard to employees.

Deductions and Contributions

Owner-employees and partner-employees (self-employed persons) are granted a yearly deduction for pension or retirement plan contributions of the lesser of $2,500 or 10% of earned income. Int. Rev. Code of 1954, § 404(e). That figure also represents the maximum permissible yearly contribution an employer may make on behalf of an owner-employee. Int. Rev. Code of 1954, § 401(d)(5). The employer may make a greater yearly contribution for a partner-employee, and under some circumstances all self-employed persons (owner-employees and partner-employees) may make additional voluntary contributions, but in no case may a self-employed person deduct more than the yearly $2,500 or 10% of earnings, whichever is less. Under a nondiscrimination rule, an employer may not contribute on behalf of employees at a lesser percentage of compensation than is applied in making contributions on behalf of owner-employees and partner-employees. Employers may contribute for employees at a higher rate but, since that would increase costs of a plan to owner-employees and partner-employees, the likelihood is that the rate of contribution (expressed as a percentage of yearly compensation) will in most cases be the same for all three sorts of employees. In any case, employer contributions for employees generally cannot exceed 15% of compensation for a profit-sharing plan, 5% of compensation (or higher "normal cost") for a pension plan, or 25% of compensation for two or more plans. Int. Rev. Code of 1954, § 404. Contributions for employees are, of course, deductible.

Owner-employees may not make voluntary contributions to a plan unless at least one employee is enrolled in the plan and is permitted to make voluntary contributions on the same basis. Int. Rev. Code of 1954, § 401(e). In the latter case, an owner-employee can voluntarily contribute $2,500 or 10% of earnings, whichever is less, yearly. The same rule applies to partner-employees where no owner-employee is involved. Earnings and gains attributable to voluntary contributions may be accumulated tax free within a plan; however, under most plans, such earnings and gains are not subject to withdrawal before distribution.

Employers may not contribute to a plan on behalf of owner-employees or partner-employees in such a way as to create or increase a net operating loss. Int. Rev. Code of 1954, § 172(d)(4)(D).

Coverage and Vesting

Where an owner-employee participates in a plan, the plan must cover all full-time employees with three or more years of experience; and all contributions by the employer on behalf of such employees become immediately vested, not subject to later divestment. Int. Rev. Code of 1954, § 401(d)(2)-(3). When the owner-employee has less than three years of service, he may not create a plan under which he is instantly covered while others must wait to accumulate three years of service. Where no owner-employee is covered, the nondiscrimination rule requires that the same waiting period and vesting provisions apply to employees as are applied to partner-employees.

The Commissioner has determined that full-time employees who divide their services between various self-employed members of an association are full-time employees of each associate served.

Excess Contributions

Stringent penalties apply where impermissibly large contributions are made on behalf of an owner-employee. The excessive contribution must be repaid, along with any earnings therefor, to the owner-employee within six months of notification of the excess. There are, of course, no deductions or tax shelters for excess contributions or earnings on excess contributions. If the excess is not repaid within six months, the owner-employee loses any deduction for proper contributions either at the time of the excess contribution or thereafter. In addition, if the excess contribution is found to have been willfully made, the entire plan loses its tax exemption for five years. Int. Rev. Code of 1954, § 401(e).

Distributions

Partner-employees and employees may receive distributions from a plan as the plan provides. Owner-employees may receive distributions only (1) on retirement, after age 59-1/2 and before age 70-1/2, (2) in the event of disability (as defined in Int. Rev. Code of 1954, § 72(m)(7)), or (3) on death.

Premature distributions on behalf of an owner-employee are stringently penalized. If less than $2,500, a distribution is taxed to the owner-employee at 110% of the tax that would have resulted if it had been included in gross income in the year of receipt. If more than $2,500, the distribution is taxed at the rate it would have been taxed if included in gross income in the year of receipt, or 110% of the increase in tax resulting if it had been received in equal portions over the five preceding years, whichever is larger. An owner-employee who accepts a premature distribution may not participate in any self-employed plan for five years thereafter. Int. Rev. Code of 1954, § 72(m).

Memorandum 71-11

EXHIBIT II

Code of Civil Procedure § 690.18 (amended)

Sec. . Section 690.18 of the Code of Civil Procedure is amended to read:

690.18.

(a) All money received by any person, a resident of the state, as a pension, or as an annuity or retirement or disability or death or other benefit, or as a return of contributions and interest thereon, from the United States government, or from the state, or any county, city, or city and county, or other political subdivision of the state, or any public trust, or public corporation, or from the governing body of any of them, or from any public board or boards, or from any retirement, disability, or annuity system established by any of them pursuant to statute, whether the same shall be in the actual possession of such pensioner or beneficiary, or deposited by him.

(b) All money held, controlled, or in process of distribution by the state, or a city, city and county, county, or other political subdivision of the state, or any public trust or public corporation, or the governing body of any of them, or by any public board or boards, derived from the contributions by the state or such city, county, city and county, or other political subdivision, or such public trust, public corporation, governing body, or public board or boards, or by any officer or employee thereof, for retirement or pension purposes or the payment of disability, death, or other benefits, or the payment of benefits payable to, or the reimbursement of benefits paid to, employees thereof under the provisions of the Unemployment Insurance Code, and all rights and benefits accrued or accruing to any person under any system established pursuant to statute by the state, city, city and county, county, or other political subdivision of the state, or any public trust or public corporation for retirement, annuity, or pension purposes or payment of disability or death benefits, and all vacation credits accumulated by a state employee pursuant to the provisions of Section 18050 of the Government Code, or any other public employee pursuant to any law for the accumulation of vacation credits applicable to such employee. Such moneys, benefits, and credits shall be exempt without filing a claim of exemption as provided in Section 690.50.

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~~(c) All money held, controlled, or in process of distribution by any private retirement plan, including, but not limited to, union retirement plans, or any profit-sharing plan designed and used for retirement purposes, or the payment of benefits as an annuity, pension, retirement allowance, disability payment or death benefit from such retirement or profit-sharing plans, and all contributions and interest thereon returned to any member of any such retirement or profit-sharing plan, are exempt from execution, attachment, or garnishment in any bankruptcy proceeding. This subdivision shall not apply to any moneys held in any retirement program established pursuant to the federal "Self-Employed Individuals Tax Retirement Act of 1962" (P.L. 87-792; 76 Stat. 809),[1] nor to any moneys received in any manner by persons from any such retirement program so established.~~

Comment. Section 690.18 is amended to delete all references to private pension, retirement, disability, and death benefit plans. Exemptions for such private plans are now dealt with in Section 690.185 (new).

Code of Civil Procedure § 690.185 (new)

Sec. . Section 690.185 is added to the Code of Civil Procedure, to read:

690.185. (a) All money received by any person, a resident of the state, as an annuity, pension, retirement allowance, disability payment, or death benefit from any private retirement plan (including, but not limited to, union retirement plans), or any profit-sharing plan designed and used for retirement purposes, and all contributions and interest thereon returned to any member of such retirement or profit-sharing plan, and all moneys paid out pursuant to the terms of an employment on account of previously accumulated vacation credits as defined in subdivision (c) of this section, whether the same shall be in the actual possession of the person entitled to them, or deposited by him.

(b) All money held, controlled, or in process of distribution by any private retirement plan (including, but not limited to, union retirement plans), or any profit-sharing plan designed and used for retirement purposes, or for the payment of benefits as an annuity, pension, retirement allowance, disability payment, or death benefit, and all rights and benefits accrued or accruing to any person under such retirement or profit-sharing plan for retirement, annuity, or pension purposes or payment of disability or death benefits, and all vacation credits accumulated by an employee pursuant to a plan for the accumulation of vacation credits adopted by his employer. Such moneys, benefits, and credits shall be exempt without filing a claim of exemption as provided in Section 690.50.

(c) As used in this section, "vacation credits" means those amounts of deferred compensation which, pursuant to the terms of an employment, regularly accumulate for the benefit of an employee over the period of his employment and are made payable to such employee upon taking of a leave of absence or leaving the employment.

(d) The exemptions contained in subdivisions (a) and (b) do not apply to:

(1) Voluntary contributions made to a retirement plan established pursuant to the federal "Self-Employed Individuals Tax Retirement Act of 1962" (P.L. 87-792; 76 Stat. 809) where such voluntary contributions are made within thirty days of issuance of a writ of execution upon assets of the maker of such voluntary contributions or thereafter until a levy pursuant to such writ is paid; or

(2) Any contributions to or distribution from such a retirement plan as described in paragraph (1), following issuance of a writ of execution against assets of the beneficiary of contributions, or distributee and until levy pursuant to such writ is paid where such contributions or distributions are made in violation of the provisions of such plan or of the federal law.

Comment. Section 690.185 is added to conform the treatment of private retirement and pension benefit plans to that accorded public plans under Code of Civil Procedure Section 690.18. The same exemptions from execution, attachment, and garnishment are made to apply in the same cases. Plans established pursuant to the federal "Self-Employed Individuals Tax Retirement Act of 1962" (P.L. 87-792; 76 Stat. 809) are included within the section as private plans.

Subdivision (a). Subdivision (a) of Section 690.185 provides an exemption for moneys received from a private plan comparable to that provided by subdivision (a) of Section 690.18 for moneys received from a public plan. It extends the exemption provided for "all contributions and interest thereon returned to any member" of a public plan to private plans. The exemption provided by subdivision (a) of Section 690.185, like that provided by subdivision (a) of Section 690.18, must be claimed under Section 690.50.

Subdivision (b). Subdivision (b) extends the exemption for moneys held, controlled, or in process of distribution by a public plan to private plans, providing an automatic exemption for moneys held, controlled, or in process of distribution by private plans like that afforded public plans under subdivision (b) of Section 690.18. Subdivision (b) of Section 690.185 also includes a provision exempting "all rights and benefits accrued or accruing to any person under a private plan." This provides protection for dependents of an employee as well as the employee himself, thus providing for the beneficiaries of a private employee the same exemption given the beneficiaries of a public employee under subdivision (b) of Section 690.18. Finally, subdivision (b) includes a provision exempting "all vacation credits accumulated by an employee pursuant to a plan for the accumulation of vacation credits adopted by his employer," thus providing private employees with the same exemption given public employees under subdivision (b) of Section 690.18. It should be noted, however, that subdivisions (a) and (b) of Section 690.185 distinguish between paid out vacation credits and unused accumulated credits. The exemption for paid out credits must be claimed under Section 690.50 while the exemption for accumulated credits is automatic. The distinction makes clear that paid out vacation credits are to be exempt in the same fashion as are other paid out benefits and recognizes the policy embodied in Section 690.18 requiring that exemptions be claimed for benefits once paid out.

Subdivision (c). Subdivision (c) defines vacation credits in substantial conformity with the definition of that term implicit in Section 690.18. Under subdivision (c), vacation credits are a form of deferred compensation substantially similar to other employer contributions to employee benefit plans.

Subdivision (d). Subdivision (d) is added to prevent use of Keogh Act plans for the sequestering of funds which ought to be available to creditors. Subdivision (d) does not affect employer contributions on behalf of employees, or distributions to employees, so long as such contributions or distributions are not in violation of the provisions of a plan or of the federal law. The Keogh Act segregates private employees into three groups: (1) owner-employees who own more than a 10% profit interest in a business, (2) partner-employees who are partners with less than a 10% profit interest, and (3) common law employees. For all of these, the federal law provides a maximum annual employer contribution to a retirement or pension plan with provisions against discrimination in favor of self-employed individuals and rules regulating annual additional voluntary contributions according to employment statutes. Voluntary contributions for owner-employees are severely restricted, and substantially the same restrictions apply to partner-employees albeit less stringently where no owner-employees are involved. Probably these restrictions will deter abuses by owner-employees in many cases. There is less deterrence in the federal law for partner-employees and common law employees. For these reasons, amended Section 690.18 provides that voluntary contributions to a private plan within one month of issuance of a writ of execution, and thereafter until the levy is paid, are not exempt; it further provides that there shall be no exemption for contributions to and distribution from a private plan after issuance of a writ and until the levy is paid if such contributions and distributions violate the provisions of the plan or of the federal law. Subdivision (d) does not remove the exemption for contributions and distributions prior to issuance of a writ of execution regardless of whether or not such contributions and distributions violate provisions of a plan or of the federal law; prior to issuance of the writ, the propriety of such contributions and distributions is the concern of the federal law, for which the federal law provides.

Keogh Act plans are discussed in Carter, Self-Employed Retirement Plans (Cal. Cont. Ed. Bar 1968).