MEMORANDUM
December 5, 2007

TO: Honorable Members of the City Council

FROM: Jay Goldstone, Chief Operating Officer

SUBJECT: The FY05 Audit and the 415 Issue

It's in the best interests of our taxpayers for the City to responsibly return to the public finance markets as soon as possible. Our City has a number of long-deferred infrastructure improvements that must be made and the public finance markets provide us with the most attractive rates to finance these improvements. Chief among these needs is the necessity to finance our water and wastewater improvement needs so that we can comply with federal and state government consent decrees. Because of these realities, Mayor Sanders' administration has been focused on the achievement of this critical goal.

An issue has been raised concerning the FY05 financial statements. The issue surrounds the City's description of SDCERS' compliance with Internal Revenue Code Section 415. Our external auditors believe that the issue has been treated accurately and responsibly and as such, they have given us a clean opinion letter for the FY05 financial statements. However, despite the auditor's opinion, at this time an attempt is being made to delay the FY05 audit based upon questions about the degree of Section 415 disclosures. These questions appear to be politically rather than legally motivated and unfortunately it's the taxpayer who will be hurt by this political jockeying.

We believe that the City has disclosed the Section 415 issues responsibly in both the transmittal letter and the footnotes of the financial statements. However, out of an abundance of caution, the mayor is willing to attach a cover letter to the document that will include the latest information that we have learned. We will also include all necessary information in the City's FY06 financial statements, an important point because the City does not expect to return to the public markets until after the issuance of our FY06 financial statements.

As a result of newly reformed financial controls and disclosure practices, Mayor Sanders believe the City will soon be ready to re-access the public bond markets so that we can more efficiently fund our City's long-delayed and much-needed infrastructure improvements. It's in the taxpayers' best interests for the City to have access to the public bond markets. Any delays in the completion of the financial statements, on the schedule that the mayor has already detailed, will have an increasingly negative impact on the residents ability to finance critical improvements at reasonable borrowing costs.

In order to clear up much of the disinformation surrounding this issue, I have written this memo to put the Section 415 issue into its proper context and to explain its relevance to our audits and the City's financial situation.

Background and History

Internal Revenue Code (IRC) Section 415 provides overall limits on contributions and benefits provided to an individual participant under any public or private qualified pension plan. In 1994, Congress created legislation under IRC Section 415(m) to give state and local governments a mechanism to pay for contractually awarded benefits that surpass these limits. While the total amount of benefits paid is the same contractually agreed upon amount, the financing vehicle to pay for the amount over the Section 415 limits is separate from the qualified pension plan.

In March 2001, the City Council amended the Municipal Code to create what the IRS calls a "Qualified Governmental Excess Benefit Arrangement" or QEBA. The action, which was entitled "Preservation of Benefit Plan," states:

> "A 'Preservation of Benefit Plan' ('Plan'), separate and apart from any other plan administered by the Retirement Board, is established and adopted to preserve the benefits otherwise earned by Members of the Retirement System to the extent their benefits are reduced by the limitations on benefits imposed by Section 415 of the Internal Revenue Code ('Code')."

This action marked the City's intention to comply with Federal Tax Code and is entirely consistent with the City Council's responsibility under the Charter to enact ordinances necessary to implement pension benefits. Article IX of the City Charter deals with "The Retirement of Employees." Section 146 of this article reads:

> "The Council is hereby fully empowered by a majority vote of the members to enact any and all ordinances necessary, in addition to the ordinance authorized in Section 141 of this Article, to carry into effect the provisions of this Article; and any and all ordinances so enacted shall have equal force and effect with this Article and shall be construed to be a part hereof as fully as if drawn herein."

Unfortunately, the former management of SDCERS did not immediately implement the newly created plan. The SDCERS Board of Administration did not formally create a Trust until February 2007. As a result of this inaction, approximately $6-8 million in benefits, above the IRS limits, were paid out to between 95-102 retirees. The difference in the number of retirees and the dollar amounts results from changes in the methodology used to compute the figures and are still under negotiations with the IRS.

As the result of a voluntary compliance review by SDCERS' outside tax counsel in 2005, the need to achieve compliance with the Internal Revenue Code was brought to the attention of the new SDCERS board and management. SDCERS recognized the implications of non-compliance and enrolled in the IRS's Voluntary Compliance Program (VCP). The VCP permits plan sponsors to correct failures of these types and thereby continue to provide their employees with retirement benefits on a tax-favored basis. Corrections related to Section 415 issues rank among the top 10 reasons that plans enroll in the VCP. SDCERS hopes to reach resolution with the IRS on this issue within the next several months.

Many governmental organizations in the State of California have a QEBA. In fact, California Government Code Section 31899.4(a) reads in part:

> "Each county and district ***shall provide*** a program to replace the benefits that are limited by Section 415 of the Internal Revenue Code for members whose retirement benefits are limited by Section 415 and cannot be fully maximized pursuant to Section 31538. The replacement benefits program shall provide benefits that, together with the benefits provided by the retirement system, are the same as, and may not exceed, the benefits that would be paid by the retirement system but for the application of the limits of Section 415." [Emphasis added]

NUMBER OF RETIREES AFFECTED AND FINANCIAL IMPLICATIONS

The methodology for calculating benefit limits is extremely complicated and will more than likely not be finalized before a settlement is reached with the IRS. The formulas used to date have produced several varying projections ranging from 11 to 29 to 102 employees that have surpassed the IRC Section 415 limits. The latest projection is that 97 employees (out of 17,647 participants or less than 1%) have exceeded the benefits limits and that these benefits are worth approximately $6.2 million. Again, these numbers will more than likely keep changing until a final agreement is made with this IRS. This is a key reason as to why the FY05 audit should not be changed; there are no final numbers. It is not yet clear whether or not the City will have to repay SDCERS for payments made to retirees above the limits in the past.

As part of the budget planning process, the City will receive an estimate from SDCERS that will be inserted into the budget. At the beginning of the each fiscal year, the City will send these funds to SDCERS. The Pension System will send two checks (totaling nothing more than their contractual retirement benefit) on a monthly basis to applicable trustees. In FY08, the City has budgeted $500,000 for these benefits. Depending on mid-year estimates given to us by SDCERS, this amount may be increased to $1.2 million.

The current estimated actuarial liability for active member benefits subject to the limit is approximately $22.8 million.

<u>CLAIMS BY THE CITY ATTORNEY</u>

In mid-November, the City Attorney issued his Interim Report 22 in which he makes several erroneous claims regarding the City's treatment of the 415 issue. I have summarized his claims below in bold and my position on each:

- **The City Attorney has called the QEBA a "second pension plan to pay for benefits considered illegal and excessive by federal law." He has also recommended that all payments should be immediately halted.**

  Interim Report 22 reads, in part: "For these individuals whose benefits exceed the IRS limits, the City has the option of directly paying for the excess benefits or not paying for these benefits. If the City chooses to pay these benefits, that obligation to pay the excess benefits out of the City's General Fund will become a second pension plan with new defined benefits."

  The QEBA is not a "second pension plan," it is merely a financing vehicle to pay for the contractually agreed upon benefits that exceed proscribed limits. The Federal government does not consider benefits paid as part of a QEBA to be "illegal and excessive." In fact, just the opposite is true. Congress established QEBA's in order to ensure that contractually stipulated benefits could be funded legally and in compliance with other sections of the IRS Code.

  The QEBA is not a "second pension plan." In fact, IRS code section 415 (m)(3) specifically states:

  > "Qualified governmental excess benefit arrangement: For purposes of this subsection, the term 'qualified governmental excess benefit arrangement' <u>**means a portion of a governmental plan**</u> if (A) such portion is maintained solely for the purpose of providing to participants in the plan that part of the participant's annual benefit otherwise payable under the terms of the plan that exceeds the limitations on benefits imposed by this section, (B) under such portion no election is provided at any time to the participant (directly or indirectly) to defer compensation, and (C) benefits described in subparagraph (A) are not paid from a trust forming a part of such governmental plan unless such trust is maintained solely for the purpose of providing such benefits." [Emphasis added]

  Further, the California Government Code specifically states that "Each county and district ***shall provide*** a program to replace the benefits that are limited by Section 415 of the Internal Revenue Code for members whose retirement benefits are limited by Section 415 and cannot be fully maximized..." [Emphasis added] and our own City Charter gives the City Council the power to enact ordinances necessary to effect pension benefits.

  The City does not have the option to pay for these benefits; only a judge can make such a decision. This matter has been adjudicated in the courts and until there is a different ruling, the City is bound to pay for these benefits. Our failure to do so could very well lead to contempt of court.

- **The City Attorney has stated that the QEBA was improperly established and that as such it was not enacted. He further asserts that there is "no provision in the City Charter that would allow for the establishment of an 'excess benefits' plan, a second pension plan separate and apart from the current plan." He concludes this line of argumentation by calling for a public vote on the issue.**

  The QEBA was properly established. Since March 2001, Section 24.1601(a) of the Municipal Code has read:

  > "A "Preservation of Benefit Plan" ('Plan'), separate and apart from any other plan administered by the Retirement Board, **is established and adopted** to preserve the benefits otherwise earned by Members of the Retirement System to the extent their benefits are reduced by the limitations on benefits imposed by Section 415 of the Internal Revenue Code ('Code')." [Emphasis added]

  The enactment of this ordinance is entirely consistent with the Council's responsibility, under the Charter section cited previously, to facilitate the payment of contractually agreed upon pension benefits.

  While it is unfortunate that SDCERS did not establish the Trust until February of this year, this delay is unrelated to the proper establishment of the Plan in 2001. The Plan was properly established. Until this issue became a political opportunity for him a few weeks back, the City Attorney had not contested its existence. At this time, we know of no further action required by the City Council.

  There is no need for a public vote. The excess benefits plan is not a second pension plan; it is merely a financing vehicle for the same set of benefits. It does not increase the overall level of benefits received by City employees; this is a critical point in considering the application of the Charter restriction on increases to employee pension benefits.

- **The City Attorney has stated the SDCERS failed to properly administer excess benefits.**

  There is no doubt that SDCERS illegally paid out benefits in excess of Section 415 limits from the qualified pension plan. However, during this time period, the system was managed by a different group of people that have since been terminated. Nevertheless, this was wrong. SDCERS' new management team recognized the errors and voluntarily enrolled in the IRS's Voluntary Compliance Program to correct the mistake and preserve the qualified status of the plan.

- **The City Attorney believes that the FY05 CAFR contains misleading disclosures related to this issue.**

  The City's external auditors do not agree with this point. Because of the small impact that the issue has on the City's financial statements, the City's external auditors did not believe that there had to be any further explanation and have given the City a clean opinion letter. As I stated earlier, out of an abundance of caution, Mayor Sanders will add a cover letter to the audit to further explain this issue and we will include additional discussion about the matter in the City's Fiscal Year 2006 financial statements. It is unfortunate that the City Attorney never raised this issue during the preparation of the FY05 financial statements.

cc: Michael Aguirre, City Attorney
Andrea Tevlin, IBA
Greg Levin, City Comptroller