



David B. Wescoe
Administrator/CEO

December 5, 2007

Council President Scott Peters
The City of San Diego
202 C Street, M.S. 10A
San Diego, CA 92101

BY HAND

Dear Council President Peters:

Re: December 6 Council Rules Committee Meeting

Thank you for soliciting my views about the recent public discussions concerning City retirement benefits that may exceed the limits set out in IRS Code Section 415.

SDCERS' Duties and Responsibilities. Before I comment on the Section 415 issues, I would like to remind everyone exactly what SDCERS' duties and responsibilities are.

First, "SDCERS is a legal entity legally independent from the City..." (The City of San Diego v. SDCERS, Complaint for Declaratory Relief, filed October 15, 2007 at p. 1.)

Second, SDCERS administers benefits, it doesn't create them. "Under the City Charter and Municipal Code, the City Council sets by ordinance the level of benefits for the various categories of employees. SDCERS administers the City's retirement system and performs various duties, including calculating annual employer and employee contributions, administering investment of the funds, and paying pension benefits to retired City employees." Order on Summary Judgment, SDPOA v. Aguirre, et al., (US District Court for the Southern District of California, Case No. 05-CV-1581 H (POR), May 18, 2007 at p. 3.)

With respect to SDCERS' administrative role, Judge Barton summarized it best in his Statement of Decision in the recent benefits litigation that the City Attorney lost:

The evidence and the City Charter and California Constitution define the duties and responsibilities of SDCERS. It is the administrative body for the pension system created by the City. SDCERS' responsibility is to administer the system and pay the benefits the City sets.... [SDCERS] does not set benefits and has no power to either set or rescind benefits. The power to create or modify benefits rests with the City. (Statement of Decision, filed January 18, 2007, at p. 28.)

Finally, retirement benefits, including any that might exceed Section 415 levels, “were created by the City and its employees in the MOU process...SDCERS has no power to create these benefits, has no power to modify these benefits and has no power to rescind these benefits.” (Id. at p. 29.) The benefit amounts that may exceed Section 415 limitations are benefits that the City agreed to pay City employees.

Section 415 Overview. Section 415(b) of the Internal Revenue Code limits the extent to which benefits may be provided from a qualified pension plan like SDCERS. The basic requirement of Section 415(b) is that an annual benefit paid to a member from a qualified plan like SDCERS cannot exceed an annual dollar limit that is calculated for members based on their age at retirement and other factors. The calendar year 2007 dollar limit is \$180,000 for a general member who retires between the ages of 62 and 65, but the dollar limit decreases rapidly depending upon a member’s age at retirement; for example, the limit is only \$91,739 for a general member retiring at age 55.

Importantly, when it enacted Section 415, Congress made clear that it was not limiting the benefits an employer may decide to provide to its employees in general.

SDCERS and Section 415. Beginning in 2005, SDCERS has been proactively and responsibly reviewing its past tax compliance with all IRS rules and regulation, including Section 415. At that time, the SDCERS Board initiated a comprehensive compliance review and retained Ice Miller LLP, one of the country’s most experienced tax and pension law firms, to oversee it.

A SDCERS member should not receive an annual retirement benefit from the SDCERS Trust Fund in excess of their Section 415 dollar limit. To comply with Section 415, SDCERS must test annual benefits paid to its members and beneficiaries. SDCERS’ tax compliance review noted that this testing was not being conducted. As a result, SDCERS supplemented its Internal Revenue Service Voluntary Compliance Program (VCP) filing on August 9, 2006 to disclose this deficiency to the IRS.

SDCERS is currently negotiating with the IRS for a Compliance Statement that will include resolution of the Section 415 issue. Cheiron, SDCERS’ actuary, has been working with the IRS to develop an appropriate Section 415 testing methodology. Based on multiple preliminary versions of this testing methodology, the number of members who received payments exceeding Section 415 limits from January 1, 1995 through June 30, 2007 has ranged from 29 to 102, and the total amount paid to them in excess of the limits has ranged from \$2.2 million to \$8.2 million. Until the IRS officially approves a testing methodology, however, SDCERS will not know with certainty the number of members affected and the payments that exceeded Section 415 limits.

The City’s Preservation of Benefits Plan. It is absolutely legal for the City to provide benefits above the Section 415 dollar limit, as long as these benefits are not paid from a qualified defined benefit plan like SDCERS. Indeed, Congress created the Qualified Excess Benefit Arrangement (“QEBA”) to facilitate the payment of benefits above the Section 415 dollar limit.

On March 19, 2001, the City Council established a Preservation of Benefit Plan (the "POB Plan") (Ordinance 0-18930) to pay the benefits the City promised its retirees that exceed Section 415(b) limits. The "Supporting Information" section of the Council's March 5, 2001 meeting minutes provides an excellent overview of the Section 415 issue, and I've enclosed a copy for your information. The Council unanimously approved the POB Plan, with you and Councilmembers Atkins, Madaffer and Maienschein voting in favor. The Council also provided that "[a]dministration of the Plan shall be under the exclusive management and control of the [SDCERS] Board." Based on this history, it is clear that by adopting SDMC §24.1603, the City Council intended to honor the City's pension obligations in a manner consistent with the Section 415 dollar limit.

The City's POB Plan permits the payment of the difference between the pension benefit that is due to a member and the Section 415 dollar limit. As provided in SDMC §24.1606, and required by federal tax law, the POB Plan will be funded entirely by the City on an annual basis. That annual amount will be determined by SDCERS' actuary in accordance with testing procedures approved by the IRS. Because the POB Plan is a "pay-as-you-go" arrangement, only City contributions for that fiscal year are allowed.

On November 3, 2006, SDCERS filed a private letter ruling request with the IRS regarding the City's POB Plan to ensure it meets all the statutory and regulatory requirements applicable to a QEBA. That request is pending, and we expect it to be acted upon shortly after the issuance of a compliance statement. Until the IRS issues the letter ruling, no payments can be made from the POB Plan.

Annual Section 415 Testing. After the IRS approves a testing methodology, SDCERS will determine each fiscal year the amount necessary to fund the pension benefits above the Section 415 dollar limit payable to retired members and beneficiaries. This amount will include a projection of all excess pension benefits payable for the fiscal year to existing and projected payees, as well as the projected cost of administering the POB Plan. SDCERS will provide this information to the City each year, and the City will fund this amount on an annual basis.

It is impossible to determine before a member retires precisely the extent to which their benefits will exceed the Section 415 dollar limit in future years. It is also impossible to predict whether the number of retirees who exceed the Section 415 dollar limit will increase in the future, remain steady or decline. This is due to the many variables involved, such as the actual Section 415(b) limits as set by Congress and adjusted by the IRS, and a variety of actuarial probabilities, such as how long the employee will work for the City, the probability of earning a vested benefit, the employee's age at retirement, the employee's pensionable compensation, how fast that compensation will increase over the course of a career, the amount in the member's DROP account at retirement (if they have one), and whether and how the benefit levels will change with respect to that employee.

SDCERS' Disclosures of the Section 415 Failures. In July 2005, Ice Miller filed SDCERS' Application for Tax Determination Letter and an initial VCP filing. Since that time, Ice Miller has conducted a comprehensive, in-depth review of SDCERS' plan operations to identify any areas of federal tax non-compliance.

On April 21, 2006, in open public session, Ice Miller made a presentation to SDCERS' Board about Section 415. In March 2007, SDCERS informed KPMG and the City about the Section 415(b) testing failures and all other SDCERS Voluntary Compliance Program filings with the IRS during the course of the City's fiscal 2003 audit and KPMG's audit review of the Pension Fund financial statements and the related notes. (The City Attorney issued a "News Release" on November 13, 2007 that states that SDCERS did not provide information about Section 415 issues to "Macias Gini, SDCERS' own auditor" or "outside auditor KPMG." Neither statement is correct.)

The retrospective testing failures of benefits actually paid in excess of annual Section 415(b) limits were disclosed in both SDCERS' FY 2004 and FY 2005 CAFRs. (This information was not included in the SDCERS FY 2003 CAFR because that CAFR was published before SDCERS became aware of the Section 415(b) violations.) The impact to the City's Unfunded Actuarial Liability due to the Section 415 issue was disclosed in the City's June 30, 2006 Actuarial Valuation. However, because SDCERS cannot pay benefits in excess of Section 415 limits, SDCERS can't include them in the City's Unfunded Actuarial Liability (UAL). The \$22.8 million liability that was excluded in the City's June 30, 2006 Actuarial Valuation represented the actuary's best estimate at that time of what the present value of these excess dollar amounts would be over the lifetimes of active SDCERS participants.

Conclusion. Given SDCERS' proactive, public and professional response to IRS issues that its own comprehensive compliance review uncovered, and the City Council's passage of the POB Plan in 2001 to deal with Section 415 limitations, how this issue became the focal point of tomorrow's Rules Committee meeting is a surprise to me. Let me end with a few key facts.

First, until the IRS finally approves a testing methodology, any prediction of who might exceed the Section 415 dollar limit and by what amount will not be known. Knowing this to be the case, the recent public disclosure of SDCERS' member names and Section 415 benefit amounts by the City Attorney was irresponsible and served no legitimate purpose.

Second, the financial impact of this issue is quite modest. With respect to the prior payment of retirement benefits from SDCERS' Trust Fund that exceeded Section 415 limits, even if those prior overpayments ultimately total \$8 million, that amount over the same time period represents about 0.7% of the City's Annual Required Contribution (ARC) payments or 0.5% of the over \$1 billion SDCERS has paid out in retirement benefits. (And remember, at least 70% of the retirement benefits that SDCERS pays come from investment gains generated by SDCERS and not City or employee contributions).

With respect to future payments, the number of members affected by Section 415 limits and the total amount due them from the City's POB Plan won't be known until the IRS approves a testing methodology. SDCERS' current estimate for FY 2008 POB Plan costs (which is based on a testing methodology that has yet to be approved) is \$1.3 million, representing:

- 0.5% of approximately \$250 million in benefits SDCERS will pay its members in FY 2008.
- 0.9% of the City's FY 2008 ARC.
- 0.1% of the City's \$1.1 billion FY 2008 General Fund budget.

In addition, the City's pension liabilities and its ARC payments to SDCERS will be reduced.

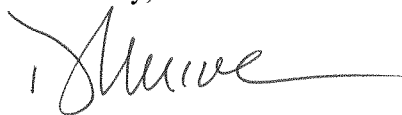
Third, retirement benefits in excess of Section 415 limits are not "illegal" or otherwise prohibited from being paid. Again, when Congress enacted Section 415, it made clear that it was not limiting benefits an employer can provide in general.

Fourth, QEBA arrangements similar to the City's POB Plan are very common in California and across the country. All 20 California counties covered by the California County Employees Retirement Law ("1937 Act Counties") have QEBAs, as do CalPERS, CalSTRS, other California city retirement systems and dozens of other state and local retirement systems.

Finally, SDCERS and the IRS have been involved in positive and productive discussions to resolve this and other IRS issues. We hope that these discussions will be concluded shortly.

Again, thank you for asking for my input. I hope that it is helpful to you and your colleagues.

Sincerely,



David B. Wescoe

Enclosure

cc: SDCERS Board of Administration
Honorable Mayor Sanders
Honorable City Councilmembers
Jay Goldstone, Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst
James V. Godsey, Macias Gini & O'Connell LLP

ITEM-202: Amendments to San Diego Municipal Code, Chapter II, Article 4, by adding Division 16 entitled "Preservation of Benefit Plan".

RETIREMENT BOARD'S RECOMMENDATION:

Introduce the following ordinance:

(O-2001-126) INTRODUCED, TO BE ADOPTED ON MONDAY,
MARCH 19, 2001

Introduction of an Ordinance amending Chapter II, Article 4, Divisions 1 and 10, of the San Diego Municipal Code by amending Sections 24.0103 and 24.1010; by adding Division 16 titled "Preservation of Benefit Plan" by adding Sections 24.1601, 24.1602, 24.1603, 24.1604, 24.1605, 24.1606, 24.1607, and 24.1608, all relating to the San Diego City Employees' Retirement System.

SUPPORTING INFORMATION:

San Diego City Employees' Retirement System ("Retirement System") is a tax qualified retirement plan that must meet the requirements of Section 415 of the Internal Revenue Code ("Code"). In certain cases, Section 415 of the Code prevents the Retirement System from paying fully earned benefits to Members of the Retirement System. The Small Business Job Protection Act of 1966 permits the City of San Diego to adopt a "Qualified Governmental Excess Benefit Arrangement" solely for the purpose of providing Members of the Retirement System the full amount of benefits that would otherwise be paid by the Retirement System but for the limits of Section 415.

The Retirement Board requests the Council of the City of San Diego to adopt a separate plan that meets the Provisions of the Code and thereby preserve benefits which cannot be paid from the Retirement System due to the limitations of Section 415 of the Code. The separate plan to be adopted for this purpose shall be known as the Preservation of Benefit Plan. It is now necessary and proper to amend the San Diego Municipal Code to adopt and set forth the terms, conditions and benefits for the Preservation of Benefit Plan. The Retirement Board has reviewed and approved the Preservation of Benefit Plan and recommends its adoption. A vote of the Retirement System's membership is not required by Charter Section 143.1.

FISCAL IMPACT:

None.

Grissom/Lexin/LC

FILE LOCATION: NONE

COUNCIL ACTION: (Tape location: C031-038.)

MOTION BY WEAR TO INTRODUCE THE ORDINANCE. Second by Stevens.
Passed by the following vote: Peters-yea, Wear-yea, Atkins-yea, Stevens-yea,
Maienschein-yea, District 6-vacant, Madaffer-yea, Inzunza-yea, Mayor Murphy-yea.

ITEM-203: Approving the Plans and Specifications and Inviting Bids for the Construction of
Sewer and Water Group 686.

(City Heights Community Area. District-3.)

CITY MANAGER'S RECOMMENDATION:

Adopt the following resolution:

Subitem-A: (R-2001-814) ADOPTED AS RESOLUTION R-294621, WITH
DIRECTIONS

Approving the plans and specifications for the furnishing of all labor, material,
tools, equipment, transportation and other expense necessary or incidental and
inviting bids for the Construction of Sewer and Water Group 686 on Work Order
No. 174731/184091;

Authorizing the City Manager to execute a contract with the lowest responsible
bidder;

Authorizing the expenditure of an amount not to exceed \$3,057,082 from Sewer
Fund 41506, CIP-44-001.0, Annual Allocation - Sewer Main Replacement,
provided that the City Auditor and Comptroller first furnishes a certificate
demonstrating that the funds necessary for the expenditure are, or will be, on
deposit in the City Treasury;

Authorizing the City Auditor and Comptroller, upon advice from the
administering department, to transfer excess budgeted funds, if any, to the
appropriate reserves;