INTERIM REPORT NO. 22

THE PENSION PLAN'S

VIOLATIONS OF

INTERNAL REVENUE CODE

SECTION 415(b) – EXCESS BENEFITS

REPORT OF THE

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I.

INTRODUCTION

Recently, Councilmember Donna Frye asked the Mayor's office multiple questions relating to the San Diego City Employees' Retirement System's ("SDCERS") legal compliance with Internal Revenue Code ("IRC") Section 415. On September 17, 2007, Jay M. Goldstone, Chief Financial Officer / Interim Chief Operating Officer responded to these questions. In one specific question, Councilmember Donna Frye asked:

> Since this $22.8 million unfunded liability results from defined benefit pension promises that are outside the proper treatment of IRS 415 limitations, how is it legal for the City of San Diego to simply assume that unfunded liability from SDCERS?
>
> Jay M. Goldstone responded:
>
> I will defer to the City Attorney for an answer to this question.

Accordingly, this report is an answer to the question presented by Councilmember Donna Frye. Additionally, in as much as the question presented involves several related issues, these related issues are also addressed herein to provide as complete an answer as possible.

II.

BACKGROUND

In 2006, SDCERS' retained actuary tested SDCERS prior payment of benefits from the City of San Diego's defined benefits plan ("Plan") to determine if the amounts paid violated the limits set by IRC Section 415(b).[1] The testing performed by the SDCERS actuary, Cheiron, determined that some of the payments previously paid by SDCERS had been paid in violation of IRC Section 415. This led to an admission by SDCERS to the Internal Revenue Service ("IRS") of these violations pursuant to an IRS program known as the Voluntary Correction Program ("VCP") (The VCP is described in more detail below). Since this admission by SDCERS, additional tests performed by Cheiron has revealed that at least 102 individuals, currently retired as of June 30, 2007, were paid benefits exceeding IRC Section 415(b) limits.[2] The benefits paid in excess of the IRC Section 415 limit currently exceed $8 million.[3]

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[1] See Employee Plans Technical Guidance, Section 4.72.6, Section 415(b), attached hereto as Exhibit 1.

[2] SDCERS' 415(b),(c), and (n) Compliance Strategy Report Revised August 2007, Exhibit E, attached hereto as Exhibit 2; The number of participants with excess benefits has fluctuated. In August 2006, the date of SDCERS initial submission to the IRS on this issue, SDCERS reported to the IRS that only 29 participants had excess benefits (*See* 9 August 2006 letter from Ice Miller to IRS, attached hereto as Exhibit 3). In February 2007, SDCERS Chief Financial Officer reported to the SDCERS board that only 18

The failure of SDCERS to comply with the benefit limits jeopardizes SDCERS' tax exempt status. SDCERS' tax counsel has advised that "if even **one** member is paid an annual benefit greater than Code Section 415 allows, or contributes more than Code Section 415 allows, **theoretically, the entire plan will be disqualified**."[4] [emphasis in original]

The City sought to downplay the significance of this issue in the transmittal letter with the 2005 City of San Diego's ("City") audited financial statement in three ways:

1. The letter attempted to reduce the significance of this violation of the IRC when it merely states that "benefits awarded to some plan participants exceed the amount permitted for IRC 401(a) pension plans such as SDCERS."[5]

2. Despite the fact that SDCERS data and reports shows that payments in excess of the IRC 415(b) limit have been made since 1993, the transmittal letter stated that in March 2001, the San Diego City Council established a Preservation of Benefits Plan ("POB"). This language in the letter gives the misleading impression that the creation of the POB automatically cures all prior violations. It does not.

3. The transmittal letter also stated that the POB "is a qualified governmental excess benefit arrangement ('QEBA')."[6] However, as shown below, SDCERS has not received the letter ruling from the IRS needed to make the plan a qualified governmental excess plan.

There is evidence which illustrates that, as early as 2001, the City was aware that these benefits were not in compliance with IRS regulations. In March 2001, the San Diego City Council amended the Municipal Code to allow for the establishment of another separate and distinct pension plan to pay benefits to those plan participants whose pension benefits exceed the IRC 415(b) limits. The new pension plan – called the Preservation of Benefit Plan, if created, – aimed to "preserve the benefits otherwise earned by Members of the Retirement System to the extent their benefits are reduced by

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participants for the year 2007 had excess benefits. In August 2007, the 18 participants grew to 102 participants when SDCERS submitted its latest testing figures to the IRS. (*See* SDCERS' Memorandum dated 7 February 2007 from Bob Wilson, Chief Financial Officer to the Board of Administration, attached hereto as Exhibit 4.)

[3] SDCERS' 415(b),(c), and (n) Compliance Strategy Report Revised August 2007, Exhibit E, attached hereto as Exhibit 2.

[4] SDCERS' 415(b),(c), and (n) Compliance Strategy Report Revised August 2007, attached hereto as Exhibit 2.

[5] 2005 San Diego City Financial Statement. The relevant sections are attached hereto as Exhibit 5.

[6] Transmittal letter of the San Diego City 2005 Financial Statements, pg. 19, attached hereto as Exhibit 6.

the limitations on benefits imposed by Section 415."[7] In other words, the Preservation of Benefits Plan would create a second pension plan in order to provide an avenue to pay retirement benefits unpayable by SDCERS under IRC Section 415.

In order for the City's pension plan to operate legally under the IRS codes, a preservation of benefits plan would have to operate as a plan separate and apart from the regular pension plan. This presents a problem for the City because there is no provision in the City Charter which allows for the establishment of an "excess benefits" plan, a Preservation of Benefits Plan, or a second pension plan to pay benefits considered illegal and excessive by federal law. Additionally, SDCERS took no steps to actually create a preservation of benefits plan until early 2007, after the voters approved Proposition B in November 2006. Proposition B required all new pension plans and pension benefit increases to be approved by the voters. Thus, the creation of a preservation of benefits plan would require the approval of the City of San Diego voters in order to create the language in the City Charter to allow for its existence. This did not and has not occurred.

The Preservation of Benefit Plan is also a direct financial obligation of the City. By law, SDCERS funds cannot be used to pay the benefits granted under a preservation of benefits plan. The City is, therefore, legally obligated to pay for the benefits included in a preservation of benefits plan out of the City's General Fund.

If the excess benefits were paid from any funds held by SDCERS, then the clear meaning and intent of IRC Section 415 would be circumvented as the total payment (legally allowed pension benefits + excess benefits) would be paid from the regular pension plan's funds. This is exactly what has occurred and continues to occur, thereby jeopardizing the status of the City's pension plan as a qualified fund. The consequences for these violations are summarized by Ice Miller as follows:

> Retaining "qualified plan" status under Code Section 401(a) is an important requirement for retirement plans. The primary advantages in retaining "qualified" status are that (i) employer contributions are not taxable to members as they are made (even when vested) and taxation only occurs when plan distributions are made, (ii) earnings and income are not taxed to the trust or the members; (iii) certain favorable tax treatments are available to members when they receive plan distributions, e.g., ability to rollover amounts; (iv) employers may "pick up" employee contributions; and (v) employer contributions to, and benefits from, the plan are never subject to employment taxes (i.e., FICA taxes). These advantages would generally not apply to a non-qualified plan.[8]

Facts detailed below provides evidence to support a conclusion that multiple material facts relating to SDCERS' violation of IRC Section 415 have been omitted from

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[7] San Diego City Municipal Code § 24.1601(a), attached hereto as Exhibit 7.

[8] SDCERS' 415(b),(c), and (n) Compliance Strategy Report, Exhibit 2, pg. 1, to the 9 August 2006 letter from Ice Miller to the IRS, attached hereto as Exhibit 3.

VCP filings made with the IRS. Errors and omissions of these types occur generally if one has not conducted adequate due diligence before they make affirmative representations. In order to protect the City's potential legal liability, SDCERS and Ice Miller need to conduct more due diligence to ensure that they have accurately stated all material facts and/or not failed to omit material facts necessary in order to make the statements made not misleading.

With that purpose in mind, in this report, the San Diego City Attorney's Office examines the Preservation of Benefits Plan and all the factors surrounding SDCERS voluntary admission to the IRS that the pension plan is not in compliance with IRC Section 415. This report investigates the question of whether or not the establishment of the Preservation of Benefits Plan should be submitted to the San Diego City voters pursuant to Proposition B. This report will discuss whether or not an independent analysis by the City's independent actuary should be made of the total cost of the excess benefits (past, present and future) in the Preservation of Benefits Plan. Finally, the San Diego City Attorney hereby recommends that no further excess payments be made unless and until these legal matters are resolved, as SDCERS, legally cannot make any excess benefit payments from its trust funds, nor can the City pay these benefits, unless and until it has legally established a preservation of benefit plan approved by the voters and the IRS.

III.

SAN DIEGO CITY PENSION

The City of San Diego has established a pension plan for City employees. The pension plan is administered by SDCERS. Since the implementation of Manager's Proposal I in 1996 -- the *quid pro quo* agreement by and between the City and SDCERS --- SDCERS has allowed the City to contribute less than its annual required contribution in exchange for the City granting a retroactive and prospective increase in pension benefits to all plan participants. The result of the under funding agreement is that SDCERS has been administered outside the purview of various federal and state laws. As a direct result of these violations of the law, several of its trustees and former City employees involved in the administration of the plan have been indicted or charged with criminal felonies. The United States Securities & Exchange Commission ("SEC') has also issued a cease and desist order finding that City officials knowingly violated federal securities anti-fraud laws for failing to disclose substantial City debt arising from the City's pension system. The City is still suffering the consequences of granting excessive pension benefits to Plan participants.

A. How the City's Pension System Works

The City of San Diego has a pension plan that pays a vested beneficiary, or retiree, an annual pension benefit is based on a number of factors, including:

(1) His/her years of credible service;

(2) A pension factor multiplier based on the person's work classification (i.e. general, safety, elected); and

(3) The individual's highest one year salary.

In general, the pension factor multiplier for general members is 2.5 percent and for safety members 3 percent. For example, a retired general member who has 20 years of credible service and who's highest one year salary was $100,000 will receive a pension benefit of $50,000 per year (20 years * 2.5%/year * $100,000) for the remainder of their life. To determine estimated benefits based on different assumptions, SDCERS has created a benefits calculator which is available online at: www.sdcers.org/benefits_calculator.jsp.

B. Explanation of 415(b) Limits and Testing

SDCERS is a defined benefit plan. IRC Section 415(b) limits the benefits payable to a beneficiary, or retiree, by a defined benefit plan. Under the rules applicable to SDCERS, the maximum benefit payable by a defined benefit plan is currently $180,000.[9] This benefit ceiling was established by the U.S. Congress in order to limit the extent to which individuals can use tax-favored arrangements to provide for retirement.[10] IRC Section 415 provides overall limits on contributions and benefits under qualified pension plans, tax sheltered annuities and simplified employee pensions. The overall limit applies to contributions and benefits provided an individual under all qualified plans, tax sheltered annuities and simplified employee pensions maintained by **any** private or **public employer** or by certain related employers.[11] Generally, the $180,000 dollar limit for defined benefit plans applies to the employer-provided portion of the benefit, expressed as a straight-life annuity. For benefits payable to non-safety employees who retire before the age of 62, the limit is reduced so that the age-adjusted dollar limit is actuarially equivalent to the unreduced dollar limit at age 62.

1. SDCERS Tax Exempt Status is Conditional Based on SDCERS Continuing Obligation to Not Commit Any Prohibited Transactions

SDCERS has received numerous warnings that the tax exempt status of the plan could be jeopardized in the event of noncompliance with the IRS codes. As Navigant Consulting, Inc. pointed out in its 2005 report to SDCERS, "[a] tax-exempt organization will lose its exempt status if it engages in a 'prohibited transaction.'"[12] IRC Section 503(b) describes a prohibited transaction as follows:

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[9] The annual salary limit was originally set at $75,000, but this amount has been adjusted for cost of living increases since 1974, and will increase to $185,000in 2008.

[10] S. Rep. 97-494(I), 1982 U.S.C.C.A.N. 781, pg 219.

[11] *Id.*

[12] Navigant Consulting, Inc. Report, pg. 63, attached hereto as Exhibit 8.

> For purposes of this section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this section:
>
> (1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;
>
> (2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;
>
> (3) makes any part of its services available on a preferential basis to;
>
> (4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;
>
> (5) sells any substantial part of its securities or any other property, for less than an adequate consideration in money or money's worth, to; or
>
> (6) engages in any other transaction which results in a substantial diversion of its income or corpus to.

The definition of a prohibited transaction was further refined by Treas. Regs. Section 1.503(b)-(1)(a) which states:

> The term prohibited transaction means any transaction set forth in section 503(b) engaged in by any organization described in paragraph (a) of Section 1.503(a)-1. Whether a transaction is prohibited transaction depends on the facts and circumstances of the particular case. This section is intended to deny tax-exempt status to such organizations which engage in certain transactions which inure to the private advantage of (1) the creator of such organization (if it is a trust); (2) any substantial contributor to such organization ….

IRC Section 503(a) provides the ramifications for committing a prohibited transaction. This code section states in pertinent part:

> (A) An organization described in section 501(c)(17) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction after December 31, 1959.
>
> (B) An organization described in section 401(a) which is referred to in section **4975(g)(2)** or (3) shall not be exempt from taxation under section 501(a) if it

has engaged in a prohibited transaction after March 1, 1954. [emphasis added]

IRC 4975(g)(2), as cited in IRC Section 503(a), refers to government plans. The SDCERS executive leadership thereby was on notice that if SDCERS commits any prohibited transaction, SDCERS is in jeopardy of losing its tax exempt status.

2. The Voluntary Correction Program

The Voluntary Correction Program of the IRS provides a method for a qualified plan sponsor that maintains a plan that experiences one or more qualification failures to seek to preserve the tax benefits of its retirement plan if the plan sponsor discovers the problems prior to the plan coming under examination by bringing such failures to the attention of the IRS. Under the IRS codes, the plan sponsor may also discover and seek to remedy the problem. Generally, under the VCP:

- The Plan Sponsor identifies the failures.
- The plan sponsor proposes correction using the General Correction Principles set forth in Rev. Proc. 2006-27, section 6.
- The plan sponsor proposes changes to its administrative procedures to insure the failures do not recur.
- The plan sponsor pays a compliance fee that generally is based on the number of plan participants.
- The IRS issues a Compliance Statement with respect to the plan detailing the qualification failures identified by the plan sponsor and the applicable correction methods approved by the IRS.
- The plan sponsor corrects the identified failures within 150 days of the issuance of the Compliance Statement.

SDCERS is currently seeking to resolve their IRC Section 415 compliance failures pursuant to the Voluntary Correction Program.

3. SDCERS Admits They Engaged in Prohibited Transactions Related to IRC 415(b), (c) and (n)

Faced with the potential for losing its tax exempt status for committing prohibited transactions, Ice Miller, legal counsel for SDCERS, wrote the Internal Revenue Service ("IRS") on 9 August 2006, and stated that SDCERS was not in compliance with IRC 415(b).[13] That letter stated in pertinent part:

[13] 9 August 2006 letter from Ice Miller to Internal Revenue Service, attached hereto as Exhibit 3.

> On July 12, 2005, the San Diego City Employees' Retirement System ("SDCERS") filed a request for a compliance statement from the Internal Revenue Service ("IRS") under the Voluntary Correction Program of the Employee Plans Compliance Resolution System pursuant to Revenue Procedure 2003-44. That filing was assigned control number 911659038. As indicated therein, that filing addressed only a correction with respect to the Presidential Leave Program. We have assisted SDCERS with a compliance review over the past months and, in the course of that review, **have identified corrections necessary with respect to the requirements contained in Section 415(b), (c) and (n) of the Internal Revenue Code of 1986**, as amended (the "Code"). This letter constitutes a supplement to the July 12th filing.[14] [emphasis added]

Attached as "Exhibit 2" to this 9 August 2006 letter was a document entitled "San Diego City Employees Retirement System 415 (b), (c) and (n) Compliance Strategy Report."[15] As identified on the title page of this report, this report was prepared by Ice Miller, LLP, attorneys for SDCERS.

Rev. Proc. 2003-44, Section 6.01 states that, "[g]enerally, a failure is not corrected unless full correction is made with respect to all participants and beneficiaries, and for all tax years." In order to minimize the financial impact of the violations, SDCERS proposed a compliance strategy sought to make a less than a full correction for their prior violations by proposing testing protocols which reduce the amount of failures in their proposed testing methodology. Specifically, SDCERS, via Ice Miller, stated to the IRS in this Compliance Strategy Report that, "as noted in the Conclusion Sections above, SDCERS wishes to make a case for a less than full correction based upon the unique facts of the situation. The testing protocols being proposed are all outlined in Sections IV and VI above."[16] In this submission to the IRS, SDCERS reported that only 29 persons were in violation of the IRC Section 415 limits.[17] SDCERS also estimated that the total overpayments paid by SDCERS in violation of IRC Section 415 was $2,266,162.[18] This submission would prove to be inaccurate.

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[14] *Id.*

[15] San Diego City Employees Retirement System 415 (b), (c) and (n) Compliance Strategy Report, Exhibit 2, attached hereto as Exhibit 3.

[16] *Id.* at 43.

[17] San Diego City Employees Retirement System 415 (b), (c) and (n) Compliance Strategy Report, pg. 29 and Exhibit F of said report, attached hereto as Exhibit 3; *See* cover letter from Ice Miller to IRS dated 9 August 2006, attached hereto as Exhibit 3.

[18] *Id.*

On 13 February 2007 and 20 February 2007, the IRS responded to SDCERS proposed Compliance Strategy Report for violations of IRC Section 415.[19] Between those two letters, the IRS raised sixteen issues with regards to SDCERS proposed IRC 415 compliance strategy. The criticism by the IRS of the proposed compliance plan ranged from differences in the interpretation of the law to outright questions of "what is the legal authority for your position." For example, the IRS in the 20 February 2007 letter states that:

> [Y]ou state that the tax law changes that added Code section 415(m) to the Internal Revenue Code provided that 415 was met for pre-1995 years and thus those years need not be tested. **We do not believe that the wording of the tax law change leads to that conclusion.**[20] [emphasis added]

In another example, SDCERS, via Ice Miller, writes in their Compliance Strategy Proposal to the IRS that:

> SDMC Section 24.1010(b) (*prior to pending amendment*) purports to make the TAMRA election for SDCERS benefits. However, the pending amendment to SDMC Section 24.1010 would remove the language referencing the TAMRA election, as it is not clear that the requirements of the election were satisfied. We recommend that the TAMRA election should be treated as repealed because it would impose the private section plan limits on certain SDCERS members, and because it is our understanding that SDCERS operated as though the TAMRA election had been repealed.[21] [emphasis in original]

In the letter to the IRS, SDCERS affirmatively represented that the Municipal Code, the Plan's guiding document, directed them to administer the plan with the TAMRA election having been made. SDCERS also admitted to the IRS that they have administered the Plan as if the TAMRA election had not been made. This action by SDCERS was in direct contravention of the Municipal Code because SDCERS has no discretion to unilaterally decide whether or not to follow the Municipal Code. Moreover, SDCERS argues that it should be allowed to treat the election as being repealed based on a pending amendment to the Municipal Code. There are two small problems with this claim by SDCERS to the IRS. First, the proposed amendment has not been passed. Second, and more importantly, the amendment to the municipal code discussed by SDCERS would be considered a revocation of the original election. Under the Internal Revenue Code, SDCERS only had three years from the date of the original election to

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[19] Letter from the IRS to Ice Miller dated 20 February 2007, attached hereto as Exhibit 9; Letter from the IRS to Ice Miller dated 13 February 2007, attached hereto as Exhibit 10.

[20] Letter from the IRS to Ice Miller dated 20 February 2007, pg. 1, attached hereto as Exhibit 9.

[21] 9 August 2006 letter from Ice Miller to IRS, pg. 17, attached hereto as Exhibit 3.

revoke its election.[22] The three years has already passed. The IRS immediately questioned SDCERS' authority to remove the TAMRA election:

> Exhibit 2, page 17, states that the plan sponsor wishes to remove the TAMRA election from the Plan. Please cite the legal authority that would allow this election, once made, to be revoked.[23]

SDCERS continued to grapple with these issues with the IRS.

4. SDCERS Retroactive IRC 415 Testing Shows at Least 102 Persons Since 1993 Have Been Paid Benefits that Exceed the IRC 415 Limits

In response to the IRS criticisms of their initial compliance plan, SDCERS submitted a revised 415(b), (c) and (n) Compliance Strategy Report to the IRS for their consideration on 20 March 2007.[24] Following that submission, representatives of SDCERS met with the IRS officials on 10 July 2007.

It is clear from the record that the IRS did not approve of SDCERS' revised Compliance Strategy Report that was submitted on 20 March 2007. This is made clear by the fact that SDCERS submitted subsequent revised filings to the IRS for their consideration. The next submission was filed by SDCERS on 22 August 2007. This document included a revised IRC Section 415 retroactive testing methodology.[25] The new methodology[26] showed the number of persons in violation of the IRC § 415 limits had grown from 29 to 102.[27] The new submission also detailed each year that these 102 people were in violation of IRC Section 415, with some violations going as far back as 1993. This is important because the older submission to the IRS included a calculation that illustrating the violations for 2006 only, which meant that the violations that occurred in the years 1993 through 2005 were excluded completely. Alarmingly, the new calculation showed that the estimated amount of overpayment from the SDCERS trust fund for the benefits in violation of IRC Section 415 rose from $2,266,162 to $8,160,027.01.[28] It is also important to note that the new methodology may still be

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[22] IRC Section 415(b)(11).

[23] Letter from the IRS to Ice Miller dated 20 February 2007, pg. 3, attached hereto as Exhibit 9.

[24] SDCERS 415(b), (c), and (n) Compliance Strategy Report, revised March 20, 2007, attached hereto as Exhibit 11.

[25] Letter from Ice Miller to the IRS dated 22 August 2007, attached hereto as Exhibit 12.

[26] Letter from Ice Miller to the IRS dated 22 August 2007, Exhibit A, attached hereto as Exhibit 12.

[27] Also, notably, Cheiron initially identified 342 participants who failed the IRC 415 test. (SDCERS' 415(b),(c), and (n) Compliance Strategy Report Revised August 2007, Exhibit A, attached hereto as Exhibit 2).

[28] SDCERS' 415(b),(c), and (n) Compliance Strategy Report Revised August 2007, Exhibit E, attached hereto as Exhibit 2

flawed because it may not account for all potential violations. The new 22 August 2007 methodology may not include calculations for those who have retired and passed away prior to 30 June 2007. This could increase the liability to City.

SDCERS sought to downplay the severity of the violations it had been committing since as far back as 1993. In an effort to avoid the fact that the benefits over the IRC Section 415 limits had to be paid by the City, SDCERS affirmatively represented to the IRS that the City had been paying into the fund amounts in excess of the annual required contribution since the VCP filings started.[29] In a chart attached to the 22 August 2007 letter, SDCERS stated that since July 2005 the City paid $142.6 million in **extra** contributions to the fund. This statement by SDCERS was an apparent attempt to "net" the City's obligations to pay the excess benefits from these claimed "extra" contributions previously made by the City.

It is unclear how SDCERS calculated the extra contribution figure. However, one figure is readily known to the City, the $100 million figure. That amount was paid into the Plan as a result of a negotiated settlement in the *McGuigan v. City of San Diego* case. In the *McGuigan* case, the City was sued for intentionally underfunding the pension. The underfunding was a direct result of the Manager's Proposal I and Manager's Proposal II agreements entered into by and between the City of San Diego and SDCERS. This pair of deals allowed the City to pay less then the actuarially determined contribution and resulted in a $1.4 billion unfunded actuarial accrued liability at the time McGuigan filed his lawsuit against the City. The plaintiffs in the McGuigan case sought money to be paid by the City into the pension plan to reduce the $1.4 billion unfunded actuarial accrued liability. The case was settled and the City agreed to pay $173 million to the pension fund to reduce the unfunded actuarial accrued liability. Following the settlement, the City immediately contributed $100 million from a tobacco securitization borrowing package it created.[30] Although the $100 million is in excess of the annual actuarially required contribution, it was paid in settlement for prior underfunding. This money therefore should not be treated as an "extra city contribution" that can be used to offset the $8 million in IRC Section 415 benefit payments that should have been paid by the City, but was paid by SDCERS.

Additionally, in light of the fact that SDCERS still has a unfunded actuarial liability of in excess of $1B, the other claimed "extra" contributions of $42,642,180 ($142,642,180 - $100,000,000) deserves additional scrutiny to determine if the City really paid "extra" contributions to SDCERS that can now be used to pay for benefits previously unknown and for which the City is directly liable for.

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[29] SDCERS' 415(b),(c), and (n) Compliance Strategy Report Revised August 2007, attached hereto as Exhibit 2

[30] Through a private placement offering, the City of San Diego borrowed $100,000,000.00 by selling approximately $10,100,000.00 of its tobacco settlement revenues. The $100,000,000.00 will be repaid to investors over the next twenty years.

C. Preservation of Benefits Fund

In 1996, the U.S. Congress enacted two special rules for governmental plans that dealt with benefits in excess of IRC Section 415. Under the two special rules benefits under a "qualified governmental excess benefit arrangement" are ignored in applying the IRC Section 415 limitations. A qualified governmental excess benefit arrangement is a portion of a governmental plan that is "maintained solely for the purpose of providing to participants" benefits in excess of the IRC Section 415 ceilings. This excess benefit arrangement is only valid if participants have no election to defer compensation under this portion of the plan and benefits are either paid directly by the employer or are paid from a trust maintained solely to provide excess benefits. Participants are taxed on benefits under a qualified excess benefit arrangement according to the rules applicable to nonqualified deferred compensation arrangements of for-profit employers (i.e. generally, when received).[31]

In order to be legal, an excess benefits plan must be established as a separate pension plan. Specifically, the Municipal Code provision by which the Preservation of Benefit Plan is allowed to be adopted states that the Preservation of Benefits Plan is "separate and apart from any other plan administered by the Retirement Board."[32] Any preservation of benefit plan is, therefore, a direct obligation of the City, not SDCERS. SDCERS funds cannot be legally used to pay the benefits granted under any preservation of benefits plan.

The Municipal Code makes clear that any preservation of benefit plan, if adopted, will have the stated purpose of "preserv[ing] 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."[33] In other words, the preservation of benefits plan grants to its participants benefits that legally cannot be paid by SDCERS. As stated above, 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 pension plan.

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[31] Bittker & Lokken, Federal Taxation of Employee Compensation, Chapter 3: Qualified Retirement Plans - Basic Rules, ¶3.6. Limits on Benefits, Contributions, and Compensation.

[32] San Diego City Municipal Code § 24.1601(a), attached hereto as Exhibit 7. The Municipal Code states that the Preservation of Benefits Plan "shall be deemed a portion of the Retirement System solely to the extent required under, and within the meaning of, Section 415(m)(3) of the Code and Article IX of the San Diego City Charter." However, this provision of the Municipal Code is overridden by the fact that the Preservation of Benefits Plan, by law, must be a plan separate and apart from that of the general pension plan.

[33] San Diego City Municipal Code § 24.1601(a), attached hereto as Exhibit 7 ; *See also* San Diego City Request for Council Action (Form 1472) and the corresponding Ordinance approved by former Deputy City Attorney Theresa C. McAteer, attached hereto as Exhibit 13.

1. The Preservation of Benefits Plan is a Separate Pension Plan Subject to the Approval of the Voters

If the City adopts a Preservation of Benefits Plan, all excess benefits have to be paid entirely by the City's general fund. For example, if a retiree receives a annual pension payment of $200,000, but $20,000 of that is deemed to be over the IRC Section 415 limit, the City must pay that $20,000 completely and on a cash basis annually. The Mayor's Office confirmed the reality of this situation. Jay Goldstone, the City's Chief Financial Officer, stated that "[a]s provided in SDMC Section 24.1606, and required by federal law, the POB Plan will be funded entirely by the City on an annual basis. No employee contribution or deferrals will be allowed into the POB Plan."[34]

The City is therefore solely and independently liable for paying the totality of these excess benefits. Employee contributions, investment returns, interest on SDCERS' trust funds, etc., cannot be used to pay any of these excess benefits. Specifically, Councilmember Frye asked this question of the Mayor's office:

> Has the IRS agreed that the City and its employees may continue to make contributions to pay for benefits that exceed the 415 limits by simply depositing those assets into this other tax deferred account thereby just shifting the assets and liability for the SDCERS pension account to this additional tax deferred account?

Mr. Goldstone responded:

> No, this is not how the POB Plan operates. SDCERS 401(a) plan and the POB Plan are independently funded and contributions will never be transferred between the two. Pursuant to tax law and SDMC Section 24.1606(e), the **City assets used to provide benefits under the POB plan "may not be commingled with the monies of any other Plan in the Retirement System, or any other qualified plans, nor may this Plan ever receive any transfer of assets from the Trust Fund established from any other plan in the Retirement System**."[35] [emphasis added]

Goldstone's comment made clear that because the employee is not paying for the excess benefits and monies from the SDCERS trust cannot be used to pay these excess benefits, then the benefits in excess of the IRC Section 415 limits are new benefits under a new pension plan. This point is highlighted by SDCERS in its 17 November 2006 PowerPoint presentation entitled "Update on SDCERS Tax Compliance IRC §415(b)

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[34] Memorandum from Jay M. Goldstone to Councilmember Donna Frye, dated September 17, 2007, pg 3, attached hereto as Exhibit 14.

[35] *Id.*

Benefit Limits."[36] On slide six of this PowerPoint presentation, SDCERS details a pension payment system where, beginning in January of every year, SDCERS pays pension up to a pre-defined limit, and when that limit is reached, the excess benefits are then paid to the beneficiary from a second plan, a preservation of benefits plan. This point is crucial because the City Charter does not allow for the City to establish new pension plans. San Diego voters in 2006 amended the City Charter as it relates to pension benefits when voters overwhelmingly approved Proposition B. The voter approved Proposition B required that any new pension benefit change must be approved by San Diego voters. Following the passage of Proposition B, the City's Charter now states:

> 143.1 Approval of Retirement System Benefits
>
> (a) No ordinance amending the retirement system which affects the benefits of any employee under such retirement system shall be adopted without the approval of a majority vote of the members of said system. No ordinance amending the retirement system which increases the benefits of any employee, legislative officer or elected official under such retirement system, with the exception of Cost of Living Adjustments, shall be adopted without the approval of a majority of those qualified electors voting on the matter. No ordinance amending the retirement system which affects the vested defined benefits of any retiree of such retirement system shall be adopted without the approval of a majority vote of the affected retirees of said retirement system.
>
> (b) Prior to any proposed amendment of the retirement system which increases benefits of any employee, legislative officer or elected official under such retirement system being placed on the ballot, the retirement system shall prepare an actuarial study of the cost due to the benefit changes proposed based upon the amortization schedules established by Charter Section 143. A summary of the actuarial study shall be published in the ballot pamphlet.
>
> (c) Nothing in subsection (a) of this section shall prevent City officials from negotiating tentative agreements with employee organizations incorporating benefit changes to the extent permitted by state law, provided, however that no amendment of the retirement system which increases benefits, with the exception of Cost of Living Adjustments, of any employee, legislative officer or elected official under such retirement system, shall become binding or effective until approved by a majority of those qualified electors voting on the matter, and shall not have any force or effect if rejected by said voters. The City Council shall have no authority to enter into final or binding agreements regarding retirement system benefits increases until and unless those increases to retirement

[36] SDCERS' 17 November 2006 PowerPoint presentation entitled "Update on SDCERS Tax Compliance IRC §415(b) Benefit Limits, attached hereto as Exhibit 17.

> system benefits are approved by a majority of those qualified electors voting on the matter.
>
> (d) The requirement for voter approval of retirement system benefit increases shall become operative on January 1, 2007, for all proposed increases in retirement system benefits tentatively agreed upon by the City on or after that date.
>
> This requirement shall remain in effect for a period of fifteen (15) years from that date, at which time this requirement shall be automatically repealed and removed from the Charter.

This is important because the establishment of the Preservation of Benefit Plan was never properly codified through the City's Municipal Code with the appropriate legal language before November 2006. Today, because of the ratification of Proposition B, the proper and legal establishment of the Preservation of Benefits would require the approval of San Diego voters. No such vote has taken place. Thus, unless and until the voters approve the Preservation of Benefits Plan, no such plan is effective.

2. The Preservation of Benefits Plan and Trust Signed by SDCERS on 16 February 2007 is Not Effective

The City Council amended the Municipal Code on 18 April 2001 to allow for the establishment the "San Diego City Employees' Retirement System Preservation of Benefit Plan and Trust." This City Council action did not properly and legally implement the program because following the amendment of the Municipal Code, SDCERS nor the City took any action to actually create the Preservation of Benefit Plan or the trust. SDCERS confirms this fact when it states that "SDMC 24.1601 et seq. **authorizes** a Qualified Excess Benefit Arrangement under 415(m) – called 'Preservation of Benefits Plan" …."[37] [emphasis added] Thereafter, SDCERS acknowledges that, in order for the Preservation of Benefits Plan to be effective, they have to actually **establish** a separate preservation of benefit plan and trust for each plan sponsor and apply for a private letter ruling approving the Preservation of Benefit Plan and Trust from the IRS.[38] Yet, it was not until 1 January 2007, after the effective date of Proposition B, that the City and SDCERS took steps to create the actual plan and trust. Indeed, the purported Preservation of Benefit Plan and Trust Agreement was executed by SDCERS' President as of 16 February 2007, two months after the City Charter changes as established by the overwhelming voter approved Proposition B took effect.[39]

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[37] SDCERS' 17 November 2006 PowerPoint presentation entitled "Update on SDCERS Tax Compliance IRC §415(b) Benefit Limits, slide 8, attached hereto as Exhibit 17.

[38] *Id.*

[39] San Diego City Employees' Retirement System Preservation of Benefit Plan and Trust, dated January 1, 2007, attached hereto as Exhibit 15.

A preservation of benefits plan cannot be unilaterally created by SDCERS or the City. It is crucial to stress that the creation of a new pension plan requires the approval of the IRS. Therefore, the amendment of the Municipal Code on 18 April 2001 was insufficient to create a preservation of benefits plan.

SDCERS has reportedly requested from the IRS a private letter ruling needed to consummate the Preservation of Benefits Plan.[40] While awaiting a reply, SDCERS stated to the IRS in a 20 March 2007 letter, "[i]n the interim, SDCERS has determined that it will seek direct payment from the plan sponsors of the excess benefits."[41] The City Attorney's Office and Macias & Gini have both verified that the City has never actually paid any of the excess benefits either directly from the general fund, any City account, or through a trust. Therefore, for all prior payments made by SDCERS, "SDCERS will invoice the Plan Sponsors for amounts paid above 415(b) limit before 2007."[42] Accordingly, a preservation of benefit plan and corresponding trust are not now nor have they ever been in existence.

D. Violations of IRC 415 Were Not Disclosed in the City's Certified Annual Financial Reports

In November 2006, the City entered into a cease and desist order with the SEC that stemmed from the City having engaged in the largest municipal securities fraud in the nation's history. As part of the agreement with the SEC, the City and its officials pledged to reform its systems and methods in order to ensure that the City never again found itself in that position again. It appears that the City is again potentially putting itself in jeopardy. Specifically, on the issue of the IRC Section 415 violations admitted to by SDCERS as it relates to the City's 2003 Certified Annual Financial Report, the City's Chief Financial Officer, Jay Goldstone, stated:

> During the period reported in the 2003 CAFR [certified audited financial report] and for previous periods, **the QEBA plan was included in the**

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[40] *See* Exhibit 3, original August 2006 SDCERS' 415(b), (c) and (n) Compliance Strategy Report, pg. 29, wherein Ice Miller states that "[w]e have recommended to SDCERS that a private letter ruling be pursued in order for the IRS to approve the POB Plan as a qualified excess benefit arrangement under Code Section 415(m) …. In the interim, SDCERS has determined that it will seek direct payment from the plan sponsors of the excess benefits." *See* also SDCERS' **20 March 2007** 415(b), (c) and (n) Compliance Strategy Report, pg. 28, Ice Miller states that "SDCERS is pursuing a private letter ruling in order for the IRS to approve the POB Plan as a qualified excess benefit arrangement under Code Section 415(m) …. **In the interim, SDCERS has determined that it will seek direct payment from the plan sponsors of the excess benefits.**" *See also* Memorandum from Jay M. Goldstone to Councilmember Donna Frye, dated September 17, 2007, pg 4, Exhibit __, wherein Jay Goldstone states, "SDCERS filed a private letter ruling request with the IRS with respect to the POB Plan, in order to ensure that it meets all of the statutory and regulatory requirements applicable to a [Qualified Excess Benefit Arrangement]. That request is pending."

[41] SDCERS' 20 March 2007 415(b), (c) and (n) Compliance Strategy Report, pg. 28, attached hereto as Exhibit 11.

[42] SDCERS' 17 November 2006 PowerPoint presentation entitled "Update on SDCERS Tax Compliance IRC §415(b) Benefit Limits, slide 10, attached hereto as Exhibit 17.

> **City's Actuarial Liabilities for the City's 401A plan**. This means that the $22.8 million was not excluded from the City's Annually Required Contribution and as such, the plan was fully expensed in the same manner as it would be under the City's Comptroller's proposed accounting treatment. **The result is that this has the same impact on the City's ending Net Assets for the period reported as if the QEBA was reported as a discrete benefit plan.**[43] [emphasis added]

Based on the law, these statements are potentially false and/or misleading at best. First, as has already been shown above, the excess benefits funds cannot be commingled with IRC Section 401(a) funds (i.e. SDCERS' funds). Second, the City's annually required contribution is based on actuarial calculations that take into account multiple factors that include the employer's contributions, the employee's contributions, the rate of return on trust's investments, etc. As made clear above and through SDCERS own correspondence, the excess benefits that make up any preservation of benefits plan must be completely paid by the City. Therefore, it was imprudent, at best, for Mr. Goldstone to represent to another public official that whether or not the excess benefits were independently accounted for, it does not matter, as the amount of the excess benefits were calculated into the City's annual required contribution which results in the same impact to the City's ending net assets.

Mr. Goldstone then compounds his erroneous statements in an apparent attempt to downplay the significance of the City failing to account for the excess benefits. However, Mr. Goldstone cannot completely brush aside the City's failure, and thus, admits that the City's 2003 Certified Annual Financial Statements are incorrect. He states:

> The City's financial statements were and still are, deemed to be reasonable and considered to be materially correct. Furthermore, the City's actuarially determined liabilities were correct in total. However, **certain other disclosures required by GASB 27 were not included in the City's 2003 CAFR. These disclosures include discretely presenting the funding progress of the plan, the description of the plan and certain other actuarial information concerning the QEBA**.[44] [emphasis added]

The City still has not made full disclosure of its liabilities even though the City knew of the IRC Section 415 problem as early as 2005.[45] During the time the 2004 and

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[43] Memorandum from Jay M. Goldstone to Councilmember Donna Frye, dated September 17, 2007, pg 3, Exhibit 14.

[44] Memorandum from Jay M. Goldstone to Councilmember Donna Frye, dated September 17, 2007, pg 3, attached hereto as Exhibit 14.

[45] On July 12, 2005, the San Diego City Employees' Retirement System ("SDCERS") filed a request for a compliance statement from the Internal Revenue Service ("IRS") under the Voluntary Correction Program of the Employee Plans Compliance Resolution System pursuant to Revenue Procedure 2003-44. *See* also,

2005 Certified Annual Financial Reports were being drafted, the City knew of and could have included these direct City liabilities in these financial statements but apparently chose not to. The qualified governmental excess benefit arrangement is described in very summary fashion in one paragraph in note 12 to the City's 2005 financial statements. A more detailed discussion is set forth on page 19 of the accompanying transmittal letter. The use of the transmittal letter for a more detailed analysis than that provided in the notes raises a concern because the transmittal letter is not actually part of the audited financial statements.

Additionally, separate from the general concern that disclosure was made only in the transmittal letter are the following particular disclosure concerns in the transmittal letter:

- First, the City of San Diego's 2005 Financial Statement does not disclose the fact that 102 participants have received in excess of $8 million in payments above the IRC 415 limit.[46]

- Second, the financial statements do not disclose the number of participants and the amount of the excess payments. Rather, the 2005 financial statement transmittal letter merely states that "some participants" exceeded the IRC 415 limit.[47] The number of participants is not disclosed nor is the aggregate amount received by these participants even mentioned.

- Third, the transmittal letter goes on to state that the "San Diego City Council established a Preservation of Benefit Plan to pay for benefits in excess of those allowed under the 401(a) plan."[48] However, this statement omits a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. Specifically, the transmittal letter fails to state the fact that the excess benefits were not paid for through the Preservation of Benefits Plan, rather, the over $8,000,000.00 in excess benefits was paid from the SDCERS IRC Section 401(a) trust funds in violation of IRC Section 415.

- Fourth, the transmittal letter compounds its own misrepresentations when it makes another misstatement. The transmittal letter states that on 16 February 2007, SDCERS adopted a trust to implement the Preservation of Benefits Plan sections of the Municipal Code adopted by the City Council in 2001. However,

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Memorandum from Jay M. Goldstone to Councilmember Donna Frye, dated September 17, 2007, pg 5, attached hereto as Exhibit 14, Jay Goldstone states that "[i]t is my understanding that the current management of SDCERS first because aware of the IRC 415(b) violation in 2005.

[46] 2005 San Diego City Financial Statements Transmittal Letter, pg. 19, attached hereto as Exhibit 6.

[47] 2005 San Diego City Financial Statements Transmittal Letter, pg. 19, attached hereto as Exhibit 6.

[48] 2005 San Diego City Financial Statements Transmittal Letter, pg. 19, attached hereto as Exhibit 6.

as already shown above, unless and until the IRS issues a private letter ruling approving of the Preservation of Benefits Plan, no plan or trust exists. This is exactly why, privately, SDCERS has represented to the IRS in communications in 2007 that SDCERS will bill the City directly for the costs of the excess benefits vs. paying for the costs of the excess benefits from a trust. Thus, the statement in the transmittal letter is inaccurate.

- Fifth, the transmittal letter contains the misleading statement that the Preservation of Benefits Plan is administered by the SDCERS Board separately from the City's IRC Section 401(a) pension plan." In fact, the Preservation of Benefits Plan, which does not exist, but even if it did, was not administered by SDCERS during all times that the Plan was in violation of IRC Section 415 since the Preservation of Benefits Plan was purportedly first established in 2001. Rather, SDCERS has made payments in excess of the IRC 415 limits to at least 102 plan participants prior to the preservation of benefits plan and/or trust ever being created. Indeed, some of these participants have received benefits in excess of the IRC Section 415 limits since 1993, eight years prior to the City first taking action to address the excess benefits issue via a preservation of benefits plan.

- Finally, the transmittal letter also contains the misleading statement that the Preservation of Benefit Plan is a "qualified governmental excess benefit arrangement (QEBA) under IRC § 415(m)."[49] In fact, as already detailed above, the legal work to make the Preservation of Benefit Plan operational has yet to be completed. SDCERS has reportedly requested from the IRS a letter ruling needed to consummate the Preservation of Benefits Plan.

Unless and until the IRS approves the Preservation of Benefit Plan, said plan remains simply a proposal. That is why SDCERS stated privately to the IRS on 20 March 2007 that "[i]n the interim, SDCERS has determined that it will seek direct payment from the plan sponsors of the excess benefits."[50]

E. The City's Financial Liability for Benefits in Excess of IRC Section 415

SDCERS attempted to quantify the current costs to the City for benefits already paid in excess of the IRC Section 415 limits. It is unclear whether SDCERS calculations were correct as the IRS has yet to formally approve their testing methodology. Moreover, SDCERS has put out two conflicting reports – one stated the overpayment is approximately $2 million, while the subsequent filing stated the overpayment in excess of $8 million.

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[49] 2005 San Diego City Financial Statements Transmittal Letter, pg. 19, attached hereto as Exhibit 6.

[50] SDCERS' 20 March 2007 415(b), (c) and (n) Compliance Strategy Report, pg. 28, attached hereto as Exhibit 11.

Another problem calling into question the credibility of the SDCERS calculations is the fact that the SDCERS testing method only accounted for one of the four categories that required testing – current living retirees. To fully establish the City past liability, SDCERS needed to retrospectively test all retirees who have passed away prior to 31 December 2006, the date used by SDCERS in their IRC Section 415 retroactive test. If there are retirees who passed away prior to 31 December 2006 and who were receiving benefits in excess of the IRC Section 415 limits, that amount should not have been paid by SDCERS and needs to be accounted for as a past liability of the City.

On a going forward basis, SDCERS needs to account to the City for the present value of future payments for retirees. SDCERS' 30 June 2006 report estimates that liability to be approximately $22,000,000.00. Specifically, in a 14 August 2007 letter from Gene Kalwarski, SDCERS' actuary, to David Wescoe, Mr. Kalwarski states:

> Approximately **$20 million** of the $140 million liabilities is not part of SDCERS' unfunded actuarial liabilities (UAL) as of June 30, 2006. This amount represents benefits in excess of IRS limitations (Section 415) and is a **direct obligation of the City**. Until the on-going work in connection [sic] the IRS VCP program is finished, we will not know the final number for this item.[51] [emphasis added]

However, on a going forward basis, SDCERS needs to also account for the present value of future payments for active members and disabled members who have not yet reached full retirement age, a number which is likely to be substantial due to the multiple pension benefit increases given to employees and the popular use of the DROP program by retiring City employees, an amount the IRS has stated must be factored into the IRC Section 415 limits. Mr. Goldstone confirmed this fact when he stated, "[a] member's DROP benefit must be included in the 415(b) limit testing, which increases the number of payees who exceed the 415(b) limits, as well as the amount by which they exceed the limits."[52]

Therefore, in truth, until the IRS accepts SDCERS proposed IRC Section 415 testing methods, both retrospectively and prospectively, the City will not know its true liability, both past and future for these payments. Indeed, Mr. Goldstone's response on this subject was, "[a]fter the IRS approves SDCERS' testing methodology, SDCERS will know the affected number of members and the exact amounts involved."[53]

Will the City's liability continue to grow? Mr. Goldstone stated that, "[t]he City Council took corrective action to eliminate Section 415(b) violations …."[54] However,

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[51] 14 August 2007 letter from Gene Kalwarski to David Wescoe, pg. 2, attached hereto as Exhibit 16.

[52] Memorandum from Jay M. Goldstone to Councilmember Donna Frye, dated September 17, 2007, pg 6, attached hereto as Exhibit 14.

[53] *Id.* at pg. 7.

[54] *Id.*

this is not in fact true. The City continues to incur and will continue to incur the direct and **total** liability for these excess benefits. No action has been taken to eliminate these excess benefits. The action the City Council took was merely to find a way to use taxpayer dollars to pay for the benefits. As Mr. Goldstone stated, "the City will pay into the POB Plan, on an annual basis, the amount necessary to pay that year's benefit above the 415 Dollar Limit."[55] As of February 2007, SDCERS says "a total of 18 retirees from the City of San Diego are projected to receive excess benefits totaling $439,962 payable through December 31, 2007."[56] Subsequently, following the IRS requiring SDCERS to revise their testing methods, SDCERS discovered that 102 participants are entitled to excess benefits. Therefore, the City's liability for the excess payments in 2007 is clearly a lot more then $439,962.00.

With each additional participant identified, the City's direct financial liabilities increase now and in the future. Yet, if one were curious to see how this liability affects the overall City budget, one would think that they should be able to find a line item expense in the City's budget for this City liability. Well, if you thought that, you would be wrong. As stated by Mr. Goldstone, "[the projected payment to SDCERS for this liability] was not specifically called out in the budget document …."[57] Which is exactly the problem – the City is not fully disclosing all its current and future financial obligations in its financial reports.

IV.

CONCLUSION

Multiple retroactive benefit increases, special pension benefits for a select few and the ability for any City employee to enter DROP have created increased pension benefits for members of the San Diego City Employees' Retirement System. Many employees and retirees that directly benefited from large increases to their retirement benefits now receive pension benefits that exceed IRC Section 415 limits established by the IRS. 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. Following the passage of Proposition B in November 2006, the creation of this additional pension plan and benefits requires an affirmative vote of the public. To this point, there has been no vote by San Diego voters to implement a preservation of benefits plan.

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[55] *Id.*

[56] SDCERS' Memorandum from Bob Wilson, Chief Financial Officer to the Board of Administration, dated 7 February 2007, attached hereto as Exhibit 4.

[57] Memorandum from Jay M. Goldstone to Councilmember Donna Frye, dated September 17, 2007, pg 8, attached hereto as Exhibit 14.

Additionally, even though the City has knowledge of these liabilities none of the past, current and future obligations have been clearly reported in the City's certified annual financial reports. In addition, the letter of transmittal – part of the 2005 CAFR -- contains the misleading disclosures outlined in Section III(D). This is exactly the same path the City took several years ago which led to the City having the now notorious distinction of having engaged in the largest municipal fraud in United States history.

The question now is whether City officials and the public will let this happen again. Until then, it is the recommendation of the City Attorney that all payments in excess of IRC Section 415 limits should immediately be halted, unless and until, SDCERS and/or the City has a legal mechanism within which to make these payments and if so directed to by the voters of the City of San Diego.

By: _____
Michael J. Aguirre
City Attorney