



THE CITY OF SAN DIEGO

November 16, 2007

Honorable Michael J. Aguirre, City Attorney
City of San Diego
Civic Center Plaza
1200 Third Ave., #1620
San Diego, CA 92101
Phone: (619) 236-6220

RE: Preservation of Benefits Plan

Dear Mr. Aguirre:

Pursuant to a request from Macias, Gini & O'Connell, the City's independent audit firm engaged to audit the City's 2006 CAFR, I have been requested to analyze and document my conclusions on "*Interim Report 22: The Pension Plans Violations of Internal Revenue Code Section 415(b) – Excess Benefits*" ("Interim Report") issued by your office on 13 November 2007.

The scope of my analysis will include:

- An assessment of the quantitative and qualitative materiality of the issues presented in your report.
- An evaluation of whether or not previously issued financial statements contain errors.
- The development of a proposed accounting treatment addressing the cumulative effect of overpayments and the prospective accounting for the 415 plan.

As part of this effort, and in effort to fully understand the facts behind your interim report as they relate to the City's financial reports, I request that you assist me by providing a written response to the following questions:

1. Did you perform and document an analysis of the quantitative materiality of 415 limit testing with respect to the aggregate and individual opinion units of the City's CAFR?
 - a. If yes:
 - i. Did you conduct a "rollover" analysis?
 - ii. Did you conduct an "iron curtain" analysis?
 - iii. Did you consider IRS guidelines concerning qualification failures?
 - iv. What was your base materiality constraint?

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- v. Please provide me with your documented support for your assessment of the quantitative materiality of issues presented in the Interim Report. Prior to the release of your interim report.

- 2. On page 3 of your interim report, you offer the following conclusion:

"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."

- a. Please provide me with the code section reference to the federal law that states retirement benefits in excess of 415 limits are "illegal and excessive".
 - i. Alternatively, if this is your personal conclusion please provide me with the precedent or other analysis that leads you to this conclusion.
 - b. Please provide me with the code section reference to the City Charter which explicitly states "excess benefits" plans or multiple plans are disallowed.
- 3. In your interim report you state that the Preservation of Benefits Plan and Trust (POB Trust) document ratified by the Chairman of the SDCERS Board of Administration was in violation of Proposition B which was approved by the voters and became effective prior to the ratification of the POB Trust Document.

Additionally, your office drafted the impartial analysis for Proposition B and stated the following in that analysis:

"In particular, the proposition provides that any ordinance that amends the City's retirement system by increasing the benefits of any employee, legislative officer or elected official shall not be adopted without approval of a majority of the qualified electors voting on the matter."

Accordingly:

- a. Please provide me with the City Council Ordinance or Municipal Code amendment that accompanied the ratification of the POB trust document.
- b. Please provide me with your documented analysis of how this action increased the cash value of benefits received by an individual employee, legislative officer or elected official.
 - (e.g. how did you conclude that the total monthly amount of dollars received by retirees increased as a result of the ratification of the POB Trust?)
- c. As plan administrator, does SDCERS have the ability to "create a plan"?

- d. Alternatively, did Council create the plan through ratification of O-18930?
4. Please provide your precedent for the following conclusion:

"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."

- a. In this regard please explain the legal structure that allows for the administration of Excess Benefit Plans by the following retirement systems:
- i. CALPERS (Replacement benefit Fund)
 - ii. CALSTRS (Teachers Replacement Benefits Program Fund)
 - iii. GESE (City of Miami Excess Benefit Plan)
- b. How is the legal structure from these plans different from the structure created in O-18930 and or the limitations of the City Charter?
5. In your interim report you state:

"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."

Accordingly:

- a. Please provide me with an analysis of the legal ramifications of such an action?
- i. Would the City be sued or be subject to a regulatory action?
 - ii. If yes,
 1. Who would be the plaintiff?
 2. What would be the probability of loss?
 - a. (remote, reasonably possible or probable)
 3. What would be your estimate of the loss?
 - iii. Please provide a narrative description of the likely sequence of events and the likely legal remedy.
- b. Please provide me with an analysis of the legal ramifications of paying "excess benefits" through the existing plan, provided the IRS issues a favorable determination letter and no other action is taken to amend the municipal code.
- i. Would the City be sued or face a regulatory action?
 - ii. If yes,
 1. Who would be the plaintiff?

2. What would be the probability of loss?
 - a. (remote, reasonably possible or probable)
 3. What would be your estimate of the loss?
 - iii. Please provide a narrative description of the likely sequence of events and the likely legal remedy.
6. As part of your report, you concluded that the cumulative effect of disallowed excess benefit distributions from the City's 401(a) plan is approximately \$8 million. Additionally, you indicated that the plan sponsor may have to pay a compliance fee or make restitution. Based on this conclusion and in order to evaluate the potential of a restatement to the 2005 CAFR resulting from an error or illegal act, I have developed the following questions:
 - a. Is this liability dependent on the result of a future action by the IRS?
 - b. Has the City (Plan Sponsor) been served with a Compliance Statement?
 - c. Has the City (Plan Sponsor) been requested to pay a compliance fee?
 - d. Has the SDCERS Board of Administration taken action to request funds, has the City been "invoiced" by SDCERS or otherwise received a demand for payment pursuant to the VCP process?
 - e. When did you first become aware of the existence of the 415 plan?
 - f. Will the City have to pay back an amount equal to the cumulative effect of disallowed excess benefit distributions to the SDCERS 401(a) trust?
 - i. If yes, (these questions assume you were aware of the VCP filing from your review of the 2005 and 2004 CAFRs subsequent and prior to issuance):
 1. When did you first recognize that the City may be subject to a legal/regulatory action that would result in a loss to the City?
 2. Is this a change in estimate?
 - g. Was this addressed in your FASB 5 letter dated September 28, 2007 or the attached Case listing provided on September 12, 2007?
 - i. If yes, please direct me to where this is contained in that document.
 - ii. If no, and in the fulfillment of your capacity as Chief Legal Advisor of the City (plan sponsor) and the principal member of City Management responsible for identifying and quantifying contingent liabilities, did you make inquiry of the VCP filing and related issues to SDCERS or the IRS in order make representations to other members of management and the independent auditors?
 1. Did this evaluation include assessing the range of loss to the City?
 - iii. Prior to issuing your FASB 5 letter, did any member of City Management or the City Council raise concerns to you regarding the efficacy of the 415 plan, its legality, or the potential for contingent liabilities to arise from negotiations with the IRS over excess benefit limitations?

- iv. Prior to issuing your FASB 5 letter did you evaluate the Financial Statements or consult with the legal advisors of any of the City's Component units to assess the potential for "spill over" of contingent liabilities to City on the basis of your knowledge that the City is financially accountable for its discretely presented component units?
 - h. What is the probability of the city incurring a loss as the result of the cumulative effect of excess benefit distributions from the 401(a) plan?
 - i. (remote, reasonably possible or probable)
 - i. Is the \$8 million your best current estimate of the loss to the City?
 - i. If not, please provide your estimation of the range of loss.
 - 1. In considering your estimate, please evaluate the potential impacts of crediting the cumulative effect of ARC payments made from years 1993 – Present made toward these benefits.
 - 2. In considering your estimate, please evaluate what the balance of cumulative overpayments was as of June 30, 2005, June 30, 2006 and June 30, 2007.
 - 3. In considering your estimate, please evaluate whether or not the "415 Testing Benefit" column presented in the data schedule of Exhibit 2 (which ties to the narrative of your report) accurately reflects the actual amount paid to retirees in the year in which they retired.
7. What happens if SDCERS loses its "Qualified" or "Tax Deferred" status per the internal revenue code?
- a. What is the likelihood of this outcome?
 - i. (remote, reasonably possible or probable)
 - b. What is the range of loss to the City that arises from this outcome?
 - c. Please describe potential legal remedies to this situation.

Given the time sensitive nature of the issues being studied, I request a response to these questions no later than November 23, 2007. To assist you in your response, I will be pleased to answer any questions you may have regarding my analysis or to provide clarification on the questions presented above. In that regard, please feel free to contact me at 619-236-6162.

Sincerely,



Gregory Levin, CPA
Comptroller

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Michael J. Aguirre
Re: Preservation of Benefits Plan
November 16, 2007

CC:

Honorable Mayor Jerry Sanders
Honorable City Council Members
Jay Goldstone, Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst
Jim Godsey, Partner - Macias, Gini & O'Connell
Anthony Neequaye, Director - Macias, Gini & O'Connell
DPWG