

March 27, 2008

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CLIENT/MATTER NUMBER
999100-0917

Jay Goldstone
Chief Operations Officer
City Administration Building
11th Floor, 202 C Street
San Diego, CA 92101

Re: **IRS Voluntary Correction Plan Settlement Agreement with
the IRS and SDCERS**

Dear Mr. Goldstone:

The City of San Diego ("City") has retained this Firm to examine the Voluntary Correction Plan agreement that was negotiated between the IRS and SDCERS. The terms of our engagement require that our Firm report to the Mayor's office in consultation with the City Attorney as deemed appropriate by the Mayor's office and or the City Council. We have reviewed the Voluntary Correction Plan agreement and have reached the conclusions set forth in this letter.

Summary Conclusions

1. **Recommendation:** We recommend that the City Council approve the Voluntary Correction Plan Agreement ("VCP Agreement") and adopt the Ordinance that is required by the IRS as a condition of implementing the VCP Settlement Agreement. If the City Council fails to timely approve the IRS' required Ordinance, SDCERS' status as a tax qualified retirement plan will be seriously jeopardized, to the detriment of all SDCERS participants. If SDCERS is disqualified, participants will realize immediate income on the present value of their benefits and have to pay taxes prior to distribution.

2. **Deadlines:** The IRS has set a deadline of April 25, 2008, for passage of the Ordinance amending the SDCERS Plan Document in accordance with the VCP Agreement. The IRS has also set a deadline of June 9, 2008, for implementation of all of the changes required by the VCP Agreement.

3. **Benefit Losses for Certain SDCERS Participants:** The VCP Agreement requires actions that will result in reduced pension benefits for certain participants. These reductions are described in more detail later in the letter. Whether the City has a legal obligation to make these participants "whole" outside of SDCERS is a separate issue that will be addressed in another letter from this Firm. However, regardless of whether or not the City has such a "make-whole" obligation, the VCP Agreement must be timely approved by the City Council to preserve SDCERS' tax qualified status.

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iii. SDCERS is to return employee contributions to Presidents, with interest, that are based on compensation and service from and with the unions. SDCERS is to issue a Form 1099R to the affected union presidents for these amounts.

iv. SDCERS is to return employer contributions to the unions that they paid for their union president's participation in SDCERS.

c. Impact: Significant.

i. Four past and current union presidents are effected by this correction as follows:

Pension Reductions

Name	Old Annuity Amount	New Reduced Annuity Amount	Old DROP Acct Balance	New DROP Acct Balance
1	10,443.76	7,634.91		
2	5,135.80	4,120.67		
3	5,967.61	3,514.54		
4	6,755.58	644.92	N/A	N/A

Payback

Name	Paid to Union by SDCERS	Paid to President by SDCERS	Owed to SDCERS by Union President for Past Overpayment
1		21,449.93	N/A
2		36,615.69	
3		20,585.14	
4		23,112.64	272,322.02

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3. "Cashless Leave Correction Program" Correction:

a. Background: Starting in 2003 members of the San Diego Firefighters Local 145 were allowed to purchase additional SDCERS service credits with some of their unused vacation balances. The IRS found that this program constituted an impermissible "cash or deferred arrangement" in violation of the Code.

b. Correction:

i. SDCERS Plan will be amended to retroactively remove the Cashless Leave Program.

ii. All Plan participants who participated in the Cashless Leave Program will have their retirement benefits (annuity payments and/or DROP balances, as applicable) reduced to remove any benefits that are attributable to a Cashless Leave conversion. Affected participants who have already begun receiving retirement payments will also have their future payments reduced to reflect past over-payments attributable to their Cashless Leave conversion.

c. Impact: Significant.

i. Affected Plan participants will have their SDCERS pension benefits reduced as follows:

ii. Affected Plan participants had their vacation balances reduced in exchange for higher SDCERS' pension benefits which can no longer be given to them. However, their vacation balances can be restored to them.

4. Retiree Health:

a. Background: The IRS has concluded that, over a number of years, SDCERS paid retiree health benefits from pension assets in violation of Code §§ 401(a)(2) and 401(h). SDCERS told the IRS that the accumulated amounts, with interest, of these improper retiree health payments was \$33,830,251.

b. Correction:

i. The Plan must be amended to remove any provision for the payment of retiree health benefits. This amendment must be effective July 1, 2005.

ii. Retiree health benefits will be paid directly by the Plan Sponsor (i.e. the City of San Diego for City employees) rather than out of the SDCERS pension trust.

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iii. The IRS is not requiring the City to pay any additional money to the Plan as reimbursement for past improper retiree health payments by SDCERS because the City made supplemental pension funding contributions to SDCERS during Plan Years ending in 2006 and 2007.

c. **Impact:** Probably Modest (but, SDCERS pension funding lawsuit against City is still outstanding.)

i. City will now have to pay for retiree health benefits outside of SDCERS. The cost to the City will be the same. The City has already implemented this change.

ii. SDCERS is still pursuing One Hundred Million Dollars (“\$100M”) from the City in its pension funding lawsuit. It is SDCERS’ position that the City paid \$100M to SDCERS for retiree health benefits, and, that money was properly allocated and spent under a Code § 401(h) retiree health account that was then maintained by SDCERS; however, in so doing, SDCERS maintains, the City underfunded the pension portion of SDCERS trust by \$100M. SDCERS continues to seek that additional \$100M in funding from the City. SDCERS’ legal counsel told me that this issue was fully disclosed to, and considered by, the IRS in reaching the VCP settlement.

5. **Required Minimum Distributions:**

a. **Background:** Section 401(a)(9) of the Code requires that pension distributions begin for former employees after they attain age 70 -1/2. SDCERS has failed to comply with this minimum distribution requirement in the past.

b. **Correction:** SDCERS must make all past due required minimum distributions and comply with this Code requirement in the future.

c. **Impact:** De Minimis. The correction is already complete and all affected participants got what was required by federal law.

6. **§ 401(a)(17) Compensation Limit Failure:**

a. **Background:** Code § 401(a)(17) limits the amount of annual compensation that can be taken into account when calculating a pension. The limit is indexed for inflation, and is \$230,000 in 2008. If a participant’s compensation from the City exceeds this amount, then such participant’s pension can only be based on compensation below that amount for years in question. SDCERS failed to follow this rule in the case of three participants.

**INTERNAL REVENUE SERVICE
VOLUNTARY CORRECTION PROGRAM
COMPLIANCE STATEMENT**

Date: **JAN 10 2008**
(to be completed by IRS)

Re: San Diego City Employees' Retirement System
SE:T:EP:RA Control Number: 911659038
Employer Identification Number: 20-1800126
Plan No.: 001

I. APPLICANT'S DESCRIPTION OF QUALIFICATION FAILURE(S)

The City of San Diego ("Plan Sponsor") is the principal sponsor of the San Diego City Employees' Retirement System ("Plan"). In accordance with state and local laws, the Board of Administration For The San Diego City Employees' Retirement System ("the Applicant") is responsible for the daily administration in regard to the Plan, and has submitted a request to the Internal Revenue Service ("the Service") under the Voluntary Correction Program for a compliance statement relating to various qualification failures under section 401(a) of the Internal Revenue Code ("Code") that they have identified. The Plan uses the twelve-month period that ends on June 30 as its plan year. The Plan is a multiple employer defined benefit pension plan that has also been adopted by the San Diego Unified Port District and the San Diego County Regional Airport Authority. The Plan is also considered a governmental plan under Code section 414(d).

Failure #1

The Plan was not amended to comply with all of the applicable requirements of the Tax Reform Act of 1986 ("TRA '86"), the Unemployment Compensation Amendments of 1992 ("UCA"), and the Omnibus Budget Reconciliation Act of 1993 ("OBRA '93") by the required dates in accordance with section 401(b) of Code and regulations thereunder.

Failure #2

The Plan was not amended to comply with all of the applicable requirements of the Uruguay Round Agreements Act; the Uniformed Services Employment and Reemployment Rights Act of 1994; the Small Business Job Protection Act of 1996; the Taxpayer Relief Act of 1997; the Internal Revenue Service Restructuring and Reform Act of 1998; and the Community Renewal Tax Relief Act of 2000 (collectively known as "GUST") by the required dates in accordance with section 401(b) of the Code and regulations thereunder.

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Failure #3

The Plan was not amended to incorporate the interim amendments required for compliance with the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") by the required date(s) in accordance with section 401(b) of the Code and regulations thereunder.

Failure #4

During the plan years that ended in 1989 through 2008, the terms of the Plan provided special retirement benefits to past and current union presidents of the San Diego Municipal Employees' Association, Police Officers' Association, and Local 145, the International Association of Fire Fighters AFL-CIO ("Unions") that were not permitted by the Code. Under Code section 401(a), retirement benefits in a qualified plan can only be provided to employees of an employer and such benefits are generally based solely on service with and compensation paid by such employer. Specifically, the following problems were noted:

- (a) The Presidential Leave Program allowed former city employees who were no longer paid employees of the Plan Sponsor to continue to participate in the Plan as active participants and have their service as union presidents counted as credited service in determining retirement benefits under the Plan.
- (b) From 1989 through February 2004, the Plan accepted employee and employer contributions (based upon compensation paid by the Unions) that were paid by the Unions even though they had not adopted the Plan as participating employers.
- (c) Starting in 2002, the Incumbent President Program allowed compensation that was paid to the union presidents by the Unions to be counted in the determination of retirement benefits under the Plan, and such amounts would be combined with any other compensation paid by the Plan Sponsor subject to a specified dollar cap.

Failure #5

Starting in the plan year that ended in 2003 the terms of the Plan were amended to provide for an impermissible cash or deferred arrangement in violation of the Code section 401(a) in regard to the Cashless Leave Conversion Program that was offered to participants who were members of San Diego Firefighters Local 145 bargaining unit.

Failure #6

During the plan years that ended in 1983 through 1991 retiree health benefits were paid by the Plan even though the terms of the Plan did not provide for such benefits. Also, the Applicant represents that the Plan is owed additional funds from the Plan Sponsor relating to unreimbursed administrative expenses associated with the administration of the retiree health benefit account from 1993 through 2006. Both actions were in

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violation of Code section 401(a)(2). The Applicant represents that the accumulated amount of improper payments (plus interest) associated with this failure is \$33,830,251.

Failure #7

During the plan years that ended in 1998 through 2005 the terms of the Plan and its operation did not comply with all of the requirements of Code sections 401(a)(2) and 401(h) as they relate to retiree health benefits because the terms of the Plan provided that earnings of the trust would ultimately be used to fund these benefits resulting in the underfunding of the Plan. While retiree health benefits were paid from the Plan's retiree health account as required by the Code, the flow of funds was structured in a manner which made it extremely difficult, if not impossible to resolve that there was no inappropriate use of the Plan's assets.

Failure #8

During the plan years that ended in 1989 through 2004 the Applicant did not comply with the provisions of Code section 401(a)(9) with respect to required minimum distributions in regard to Plan participants who were owed a lump sum or a partial lump sum distribution. With respect to this failure, the Applicant requests a waiver of the excise tax under Code section 4974.

Failure #9

During the plan years that ended in 2000 through 2005 the Applicant allowed the retirement benefits for three participants to be determined using participant compensation that exceeded the limits imposed by the provisions of Code section 401(a)(17).

Failure #10

During the plan years that ended in 2002 through 2006 the Applicant did not comply with the provisions of Code section 401(a)(31) in regard to those participants who received eligible rollover distributions from the Plan.

Failure #11

During the plan years that ended in 2001 through 2006 the Applicant did not follow the terms of the Plan when the Applicant increased disability retirement benefits in regard to disabled plan participants by increasing their final compensation amount by 10% and using this revised figure to determine disability benefits. The Applicant represents that overpayments were made to 146 participants and that the accumulated amount of overpayments plus interest associated with this failure is \$1,221,543.

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For all plan participants who took part in the Cashless Leave Conversion Program, the Applicant will recalculate their benefits under the Plan and the Plan's records will be updated to reflect reduced benefits and service credits. Retirement benefits under the Plan, including DROP, will be determined without regard to cashless leave amounts. For those impacted participants who are in retirement status, the monthly annuity that is currently being paid by the Plan will be reduced to the recalculated amount. The Applicant will recover any overpayments that have been paid to retired plan participants by reducing the revised monthly pension benefit further on a going forward basis via a special actuarial reduction that allows the overpayment to be recouped over the participant's remaining payment period.

Failure #6

The Applicant and Plan Sponsor have represented to the Service that the Plan Sponsor has fully corrected this failure by having made supplemental contributions to the Plan during the plan years ending in 2006, 2007 and the current plan year that exceeded the amounts specified by the Plan's actuary in regard to the mandatory actuarial required contributions ("ARC").

Failure #7

The Applicant and Plan Sponsor agree that in order to comply with all of the requirements of Code sections 401(a) and 401(h) the payment of retiree health benefits must be funded by separately designated employer contributions and cannot be funded (directly or indirectly) from pension assets, including plan earnings. Effective as of July 1, 2005, retiree health benefits were no longer paid out of the Plan's 401(h) account. Instead, such benefits were paid directly by the Plan Sponsor without the involvement of the Plan. To codify this action, the Plan Sponsor will amend the Plan to retroactively to remove these provisions effective as of July 1, 2005.

Failure #8

The Applicant represents that no annuity payments were paid in violation of the required minimum distribution requirements. The Applicant represents that the lump sum or partial lump sum payments have been made to all affected participants who were past their required minimum distribution date. The distribution amounts included additional amounts for interest relating to the delayed payment.

Failure #9

In terms of one affected participant who terminated without a vested pension, the Applicant represents that the failure only resulted in the computation of excess employee contributions and that no additional action needs to be taken since the excess amounts of \$420.89 were paid out as a lump sum in 2002 that was not rolled over.

In terms of the other two affected participants, the Applicant will recalculate their benefits under the Plan and the Plan's records will be updated to reflect reduced

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benefits. Retirement benefits under the Plan, including DROP, will not be determined using participant compensation that exceeds the limits imposed by Code section 401(a)(17). The Applicant will distribute the employee contributions associated with the excess compensation plus interest to the affected participants. The Applicant will send a letter to each participant informing them that the corrective distribution is taxable, not eligible for favorable tax treatment and cannot be rolled over as normally allowed under Code section 402(c). The Applicant also agrees that the distribution will be reported on forms 1099-R for the calendar year in which the distribution is made to the affected participants.

Failure #10

The Applicant has proposed to take no action in regard to the past distributions that were made during the period of failure. As noted previously for Failure #1, the Plan Sponsor will amend the Plan to contain language that allows it to meet the statutory requirements of Code section 401(a)(31). The Applicant has changed its administrative procedures in order to ensure that all future eligible lump sum distributions paid out by the Plan will comply with the requirements of Code section 401(a)(31).

Failure #11

The Applicant has stopped paying out excess disability benefits that are not authorized by the terms of the Plan and the 10% compensation adjustment is no longer applied in computing these benefits. In regard to the overpayments that were paid out during the period of failure, the Applicant and Plan Sponsor have represented to the Service that the Plan Sponsor has fully reimbursed the Plan by having made supplemental contributions to the Plan during the plan years ending in 2006, 2007 and the current plan year that exceeded the amounts specified by the Plan's actuary in regard to the mandatory ARC contributions.

Failure #12

The testing methodology that was used by the Applicant to determine an individual's limit under Code section 415(b) during the period of failure is set forth within the document entitled "San Diego City Employees Retirement System 415(b), (c) and (n) Compliance Strategy Report" with a revision date of December 5, 2007 prepared by the Applicant's representative, Ice Miller as supplemented by Exhibits A and B with the same revision date prepared by the actuary, Cheiron. These documents are considered attached to and made a part of this compliance statement.

The Applicant has agreed that payments from the Plan during this current limitation year will not exceed the limits of Code section 415(b). If necessary, the payments being made to current retirees and/or beneficiaries will be reduced by the Applicant in order to ensure that the benefits paid out by the Plan do not exceed the applicable limits of Code section 415(b).

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The Applicant and Plan Sponsor have represented to the Service that repayments of the overpayments should not come from the affected participants since the Plan Sponsor is obligated to pay these excess benefits due to the existence of a Code section 415(m) plan and the laws of State of California. The Applicant and Plan Sponsor have also represented to the Service that the Plan Sponsor has fully reimbursed the Plan in regard to the overpayments plus interest by having made supplemental contributions to the Plan during the plan years ending in 2006, 2007 and the current plan year that exceeded the amounts specified by the Plan's actuary in regard to the mandatory actuarial required contributions ("ARC").

Failure #13

The Plan Sponsor will retroactively amend the terms of the Plan to conform to the Plan's operation in regard to this matter.

Failure #14

The Plan Sponsor will retroactively amend the Plan to indicate that the amount of employer contributions that must be paid to the Plan by the Plan Sponsor will no longer be based upon any Memoranda of Understanding between the Plan Sponsor and the Applicant. The amendment will be effective as of July 26, 2004 and it will allow the terms of the Plan to conform to the Plan's operation in regard to this matter.

III. APPLICANT'S REVISION OF ADMINISTRATIVE PROCEDURES

Failures #1, 2 & 3

The Applicant is working with outside tax counsel who will advise them in regard to changes in the Code that require amendments to be made to the Plan. The Applicant and Plan Sponsor will work together to ensure that the Plan document is updated in a timely manner for tax law changes. The Applicant has indicated that it will apply for a Cycle C determination letter in accordance with the applicable timeframes currently set forth in Revenue Procedure 2007-44.

Failure #4

The Applicant no longer permits the Unions to make any contributions to the Plan. Only contributions from the Plan Sponsor and participating employers will be accepted. The Applicant has hired outside tax counsel who will assist in ensuring that future changes to the Plan are in compliance with Code section 401(a) requirements.

Failure #5

The Plan Sponsor will not adopt any future amendments to the Plan that result in a cash or deferred arrangement. The Applicant has hired outside tax counsel who will assist in ensuring that future changes to the Plan are in compliance with Code section 401(a) requirements.

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Failure #6

The Applicant has changed its procedures and it and the Plan Sponsor now realize that retiree health benefits cannot normally be paid by the Plan and that the expense of administering retiree health benefits cannot come from the Plan's assets.

Failure #7

The Applicant has hired outside tax counsel who will assist in ensuring that future changes to the Plan are in compliance with Code section 401(a) and other applicable requirements under the Code.

Failure #8

The Applicant has implemented a new annual monitoring system that will ensure that all required minimum distributions begin on a timely basis and include benefits under the Plan with respect to all types of Plan participants and beneficiaries.

Failure #9

The Applicant has revised its software, testing protocols and internal reports to monitor participant compensation and cut it off when it reaches the appropriate limits under Code section 401(a)(17). Employee contributions will be cutoff and no retirement benefits will be based on the excess compensation.

Failure #10

The Applicant has educated its workforce in regard to the various benefits of the Plan that are subject to Code section 401(a)(31) by creating a detailed chart. Formal, detailed procedures that reflect how the Plan will comply with Code section 401(a)(31) have been written and the Applicant will use these documents when administering the Plan in regards to this matter.

Failures #11, 13 & 14

The Applicant agrees not to administer the Plan and/or provide benefits in a manner that is not explicitly authorized by the Plan. If the Applicant believes that the Plan's operation needs to be changed it will work with its tax counsel and the Plan Sponsor to have the Plan amended before changing the Plan's operation.

Failures #12

The Applicant has revised its administrative procedures for ensuring the Plan's compliance with the limits of Code section 415(b) as detailed within the previously referenced document entitled "San Diego City Employees Retirement System 415(b), (c) and (n) Compliance Strategy Report" with a revision date of December 5, 2007 prepared by the Applicant's representative, Ice Miller as supplemented by Exhibits A and B with the same revision date prepared by the actuary, Cheiron.