

THE CITY ATTORNEY

CITY OF SAN DIEGO

Jan I. Goldsmith

CITY ATTORNEY

1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE (619) 236-6220
FAX (619) 236-7215

October 3, 2011

REPORT TO THE HONORABLE
MAYOR AND CITY COUNCIL

SPSP VOLUNTARY CORRECTION PROGRAM--2010 CAFR

INTRODUCTION

During the September 26, 2011, Audit Committee hearing on the City's Fiscal Year 2010 Comprehensive Annual Financial Report (CAFR), the Committee requested a status report on the remediation of the City's compliance issues regarding the Supplemental Pension Savings Plan (SPSP) and whether this matter should be disclosed in the CAFR. The City is currently undertaking corrections through the Internal Revenue Service's (IRS) Voluntary Correction Program (VCP) and believes that the process may take as long as a year to complete. Due to the relatively small potential loss to the City in terms of corrections and penalties, this matter does not meet the City's materiality standard for disclosure in the CAFR.

DISCUSSION

In 2009, 2010 and 2011, unrepresented employees and employees represented by the MEA were given an "election" between a 3% salary reduction and waiving their 3% employer matching contribution to SPSP (matching the employee mandatory contribution). This election was in violation of the plan document. If the City does not correct the individual violations, the matching employer contributions would be taxable income to the affected employees in the years in which the City made the contributions. The City must also amend W-2 forms for approximately 1,600 employees to show these contributions as taxable income. In addition, the plan could be disqualified.

To preserve the plan's tax qualification, on May 10, 2011 the City Council approved prospective and retroactive amendments to the SPSP program by Resolution R-306805 and approved filing a VCP application to obtain IRS approval of the retroactive plan amendments. The cost of filing the VCP application is \$25,000 and the anticipated cost of outside tax counsel on this matter is \$20,000.

The cost of reimbursing the employees for their tax penalties is expected to be between \$70,000 and \$100,000. In addition, the City must pay additional Medicare taxes of approximately \$100,000 before October 31, 2011, because unlike employer contributions to a qualified plan, elective deferrals must be included in Medicare wages. There is a potential

penalty of approximately \$300,000 if this payment is late, but the City expects to make the October 31 deadline. The potential penalty for correcting the employee W-2 forms is approximately \$320,000. The IRS typically waives this penalty where the employer demonstrates "reasonable cause" for the error. The City expects that this penalty will not be imposed, given that the City is bringing this error to the attention to the IRS and voluntarily making the required corrections.

While the VCP process is not yet complete, the City expects the cost of correcting the violations related to the SPSP waiver to be between \$200,000 and \$250,000 and that no penalties will be assessed. The City may also seek reimbursement from third parties.

The required amounts necessary to make the corrections are not considered material in the context of the CAFR. The potential liability at issue is a contingent loss. Such matters are disclosed in the CAFR under note 18 (Contingencies). The materiality standard applied by the City Comptroller for the disclosure of loss contingencies is \$2 million. Because the potential loss here, even in a worst case scenario, is considerably below that \$2 million threshold, we do not believe it is necessary to disclose the SPSP VCP matter at this time.

CONCLUSION

The VCP process regarding the City's SPSP violations is ongoing and may not be completed until next year. Any losses to the City related to the VCP are contingent in nature and will not be known until the conclusion of the process. Even in the worst case scenario, the potential loss to the City associated with this matter does not rise to the materiality level for disclosure in the City's CAFR.

Respectfully submitted,

JAN I. GOLDSMITH, City Attorney

By 
Brant C. Will

BCW:jdf
RC-2011-37