

City of San Diego  
**MEMORANDUM**

DATE: April 3, 2008  
TO: CITY ATTORNEY – Catherine Bradley  
FROM: Office of the City Clerk – Mary Zumaya  
SUBJECT: Item 332 B of the April 1, 2008 p.m. City Council Meeting

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ITEM-332: Tax Ordinance Amending Retirement Plan Consistent with IRS Compliance Statement.

**MAYOR SANDERS' RECOMMENDATION:**

Introduce the ordinance in Subitem B:

Subitem-B: (O-2008-133)

Introduction of an Ordinance amending Chapter 2, Article 4, of the San Diego Municipal Code by amending Division 1, Sections 24.0103 and 24.0103.1; by amending Division 2, Sections 24.0201 and 24.0202; by amending Division 3, Sections 24.0301 and 24.0302; by amending Divisions 8, Section 24.0801; by amending Division 9, Sections 24.0901 and 24.0902; by amending Division 10, by renumbering Section 24.1000 to Section 24.1001, Section 24.1005 to Section 24.1003, by amending the renumbering Section 24.1010 to 24.1004, by renumbering Section 24.1011 to Section 24.1005, Section 24.1012 to Section 24.1006, Section 24.1013 to Section 24.1007, and Section 24.1014 to Section 24.1008, and by adding Section 24.1009; by repealing Division 12, Section 24.1203 and amending Section 24.1204; by repealing Division 13, Section 24.1310(c), by repealing Division 14, Section 24.1402(b)(9), by repealing Division 15, Section 24.1502(a)(5); all relating to the San Diego City Employees' Retirement System.

**SUPPORTING INFORMATION:** On July 12, 2005, the SDCERS Board of Administration ("Board") filed a Form 5300 application with the Internal Revenue Service ("IRS"), seeking a favorable determination letter to confirm its tax-qualified status. On that date, the Board also filed a request for a compliance statement under the Voluntary Correction Program ("VCP") of the IRS' Employee Plans Compliance Resolution System. The VCP is a program that allows a plan to voluntarily disclose to the IRS plan document or operational qualification failures it has discovered in its plan, propose corrections and ultimately receive IRS approval of corrections.

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SDCERS' initial VCP filing concerned the "presidential leave" benefit that was created by the City to allow the presidents of certain City employee labor unions to continue to participate in SDCERS while serving as union presidents, and to receive a retirement benefit based on union compensation and combined City and union service. Between July 2005 and August 2006, SDCERS filed eight supplemental VCP filings that identified other violations, and proposed corrections and remedial plan amendments.

On December 18, 2007, the IRS issued a proposed Compliance Statement, resolving all of SDCERS' VCP submissions. The Compliance Statement was signed by the Board President, on behalf of the Board, and by the City's Chief Operating Officer, on behalf of the City, on December 20, 2007. The Board unanimously ratified the Compliance Statement on December 21, 2007. The IRS signed the Compliance Statement on January 10, 2008. The Compliance Statement requires that the City Council adopt certain of the amendments contained in this ordinance.

On January 25, 2008, the IRS issued SDCERS a favorable Determination Letter, confirming SDCERS' tax-qualified status. The Determination Letter is contingent upon the City Council's adoption of all of the amendments contained in this ordinance (which has been approved by the IRS) on or before April 25, 2008.

The Technical Tax Ordinance contains the following amendments, which are in most cases required by both the Determination Letter and the Compliance Statement:

- 1) amendments necessary to conform the plan to relevant provisions of the following federal laws: the Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1986, the Omnibus Budget Reconciliation Act of 1990 (collectively referred to as "TRA '86"), the Unemployment Compensation Amendments of 1992 ("UCA '92"), the Omnibus Budget Reconciliation Act of 1993 ("OBRA '93"), the Uruguay Round Agreements Act ("GATT"), the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), the Small Business Job Protection Act of 1996 ("SBJPA"), the Taxpayer Protection Act of 1997 ("TRA '97"), the Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA '98"), and the Community Renewal Tax Relief Act of 2000 ("CRA" and together with GATT, USERRA, SBJPA, TRA '97, and RRA '98 are referred to as "GUST"), and interim good faith compliance amendments with respect to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") (required by the Compliance Statement (Failures #1-3);
- 2) retroactive elimination of the "presidential leave" benefit (required by the Compliance Statement (Failure #4);
- 3) retroactive elimination of the "cashless leave conversion" benefit, which allowed City employees in the San Diego Firefighters Local 145 bargaining unit to convert to SDCERS service credit the "cash equivalent" of the accumulated annual leave they accrued after June 30, 2002 (required by the Compliance Statement (Failure #5);

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- 4) elimination, retroactive to July 1, 2005, of all SDCERS Plan provisions relating to the 401(h) retiree health account, and all provisions that require or allow the use of SDCERS Trust Fund assets to pay retiree health benefits or the costs of administering retiree health benefits (required by the Compliance Statement (Failure #7));
- 5) retroactive elimination of the SDCERS Plan provision stating that employer contributions will be based upon a Memorandum of Understanding entered into between the City and SDCERS, substituting language providing that effective, July 26, 2004, the amount of employer contributions the City must pay to the Plan will be determined by the Board based upon the advice of its Actuary (required by the Compliance Statement (Failure #14)); and
- 6) provision of state-mandated domestic partner benefits retroactive to January 1, 2005, to conform to plan operation (required by the Compliance Statement (Failure #13)); and
- 7) provisions stating that the Board will adopt by Rule: (a) member contribution rates, (b) interest rates credited to member contribution and DROP accounts, and (c) mortality, service and other tables it deems necessary, and that these Rules are incorporated into the SDCERS Plan Document (required by the Determination Letter).

The IRS has negotiated and approved all of the amendments contained in this Ordinance. This Ordinance has also been reviewed and approved by attorney Samuel Hoffman, tax counsel retained by the City for this purpose. Mr. Hoffman's analysis and conclusions regarding the IRS *Voluntary Correction Plan Settlement Agreement and the proposed Tax Ordinance* are presented in Attachment 2. Final adoption of this Ordinance, on or before April 25, 2008, is necessary to maintain the qualified status of the SDCERS Plan.

#### FISCAL CONSIDERATIONS:

The proposed Ordinance formally eliminates or amends a number of pension plan elements. Some of these changes have already been instituted. The changes have financial impacts to certain employees, the City and the Retirement System. The status of implementation as well as a description of the impacts are described in Mr. Hoffman's letter (Attachment 2).

The IRS's favorable determination letter is contingent upon the adoption of these amendments. Failure to adopt the amendments could result in the disqualification of the plan, which would result in immediate taxation of vested benefits to the members, taxation of member contributions, and taxation of the trust fund's earnings. For FICA-covered positions, the employer contributions to a disqualified plan would be subject to FICA taxation as well as income taxation. Employees would lose favorable distribution provisions - for example, they would be unable to rollover distributions from the disqualified plan.

Goldstone

City Attorney

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**COUNCIL ACTION WAS:**

***Subitem-B: Motion***

by Madaffer, second by Peters to **introduce as amended** the IRS-Approved ordinance in Subitem B with the inclusion of the §24.0103 **Definitions** "*Rule(s)*".

Prepare a separate parallel ordinance as referred to in my attachment titled, "Transcript of Tax Ordinance Retirement Plan IRS Compliance Statement\_Item 332".

**Please prepare the Ordinance to reflect Council's Action using the appropriate language, and return to the Dockets Section at the City Clerk's Office for further processing.**

**COUNCIL VOTE WAS:**

Unanimous; all present.

Mary Zumaya, Deputy City Clerk

Item 332 Amending the Tax Ordinance Retirement Plan Consistent with the IRS Compliance Statement

**HOFFMAN:** A determination letter is given from the IRS. It is just a one and a half page sheet of paper. It says we've looked at it as if the plan is qualified and often times, as the IRS says, you must pass the amendment that is attached and the scope of the determination letter is based on the information that you gave them because the IRS has to formulate their opinion. So if you don't tell them something and they say it is a qualified plan but you did not tell them anything about a particular issue you cannot rely on--the IRS can still criticize you. So the legal question here is with respect to this determination letter. Was the IRS alerted to the fact that the union presidents were spending their full time doing union work and not doing city work even though they were on the city payroll? When I put that language in there, I thought that would be a good idea for the City based on all the issues that have happened that we ensure that the facts are presented to the IRS to make sure that they know that these union presidents are in fact spending a bulk of their time being union presidents.

Now with respect to the current letter, I talked to Ms. Mumford and when she told me they had been given these MOU's and when she had said they are on special assignment, while it is not the lengthiest description of it, it does say that the union president will be a full time city employee. It says the president will retain the rights and duties and during normal working hours the president will be subject to applicable provisions of law and normal working hours which means 8:00 a.m. to 5:00 p.m. Monday through Friday or an equivalent schedule approved in advance by the City Manager.

It struck me, as I read all this, that the IRS has enough information to be informed that these union presidents were not acting as payroll clerks or they were not acting as policeman or fireman. They were acting as union presidents but the city continued to have some control over their hours. The City Manager had to set it so my conclusion, after I looked at all that, was that that determination letter approved the union presidential

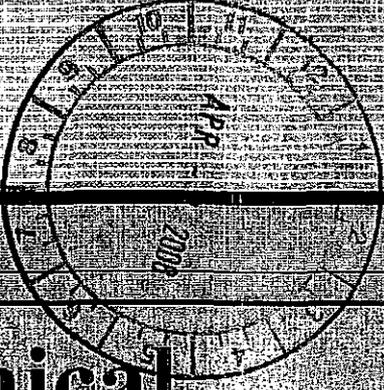
leave with the unions being on full salary but doing mostly union work as reflected in this MOU and in the follow up letter.

We already satisfied it through this determination letter. The reason I thought it was important was that you have another determination letter coming up and you'll have in five years another one and it would be, in my opinion, important that those facts how they evolve over time be fully laid out to the IRS in the determination letter so that when you get that one and a half page letter that says this is a qualified plan you know that they were told about all aspects of presidential leave and that was the point of that.

In answer to Mr. Madaffer's question, you certainly could do that if you wanted to in a separate ordinance you could insist that that sort of factual presentation be made. You could do it here, as far as I'm concerned. I do not believe that will invalidate the favorable determination although I agree and I have said that we should not tamper with this because the IRS has blessed it. Those are my conclusions and my recommendations here.

**AGUIRRE:** If what Mr. Hoffman says is that we can achieve the same result by just doing a companion ordinance, for the second reading, we will come back with an ordinance we can pass. The other ordinance basically incorporating the same language which gives the City the protection and we can approve this one as is.

**PETERS:** When the second reading of this comes back pursuant to this motion, we will bring a separate parallel ordinance incorporating the language that Mr. Hoffman had said.



**Explanation Of Technical  
Tax Ordinance**

**San Diego City Employees'  
Retirement System**

**April 1, 2008**

**Terry A. M. Mumford**  
**Terry.Mumford@icemiller.com**



**ICEMILLER**LLP  
LEGAL COUNSEL

# SDCERS And The IRS Reached Agreement in Voluntary Correction Program

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- December 21, 2007 – SDCERS Board approved Compliance Statement with IRS.
- January 10, 2008 – IRS signed off on Compliance Statement.
- January 25, 2008 – IRS issues favorable determination letter for SDCERS.
- Although these are two separate documents, they are the result of a 2½ year process designed to resolve all tax compliance issues – both in the Municipal Code and in SDCERS operation.

# SDCERS Board Took This Path To Make SDCERS A Model of Best Practices

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☐ "The resolution of the VCP process with the IRS is a tremendous accomplishment for SDCERS. We proactively approached the IRS and identified past violations, and then worked cooperatively with them to develop and implement a remediation plan.... I am proud of the continued commitment of SDCERS Board members and staff to get it right and keep it right."

— SDCERS Board President Thomas Hebrank, 12/21/07

# Obtaining IRS Approval Of The Compliance Statement And Obtaining A Favorable Determination Letter Is A Good Result

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- These two documents protect employees, retirees, and taxpayers by preserving the qualified status of the SDCERS Plan.
- These two documents protect taxpayers because the IRS is not seeking any penalty payments, and is not requiring the City to make any additional contributions.

# The Qualified Status of SDCERS Depends On The Council's Adoption Of The Tax Ordinance

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- The favorable determination letter is subject to adoption of Technical Tax Ordinance.
- Many aspects of the Compliance Statement are also dependent on adoption of Technical Ordinance.

# The Technical Ordinance Has Been Approved, Word-By-Word, By The IRS

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- The Technical Ordinance was attached to the IRS determination letter that the plan was qualified.
- The IRS has said that the Technical Ordinance must be adopted by April 25, 2008.
- Failure to adopt the Technical Ordinance (and failure to comply with the Compliance Statement) means that SDCERS would not be considered by the IRS to be qualified.

# The Amendments In The Technical Ordinance Fall Into The Following Categories

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- Category #1: Adoption of IRS required language into the plan document.
- Category #2: Bringing the plan into compliance with state law and City legal settlements.
- Category #3: Elimination of provisions that are not permissible under the Internal Revenue Code.
- Category #4: Definition of the "plan document."

## Category #1: The Tax Ordinance Contains Required Amendments To Maintain Compliance With Federal Law

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- The Municipal Code had not been updated over the years to fully comply with federal law changes. The Tax Ordinance contains every change that needs to be made to bring the Municipal Code into compliance.
- The Tax Ordinance eliminates SDCERS Plan provisions relating to the 401(h) retiree health account and all provisions that require or allow the use of SDCERS Trust Fund assets to pay retiree health benefits or the costs of administering retiree health benefits.
- The Compliance Statement also requires that these changes be made to that the plan can be operated consistently with the Municipal Code and thereby in compliance with federal law.

## Category #2: The Tax Ordinance Brings The Plan Into Compliance With State Law and City Legal Settlements

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- The Municipal Code had not been timely amended to incorporate the state law recognition of domestic partners. The Tax Ordinance fixes that.
- The Municipal Code had not been amended to incorporate the Gleason settlement. The Tax Ordinance fixes that.

### Category #3: The Tax Ordinance Eliminates Provisions That Are Not Permissible Under The Internal Revenue Code

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- The IRS has determined that the previous Presidential Leave program cannot be part of the SDCERS plan. The IRS has required that this program be retroactively removed. A new provision has been added.
  
- The IRS has determined that the "cashless leave" program cannot be part of the SDCERS plan. The IRS has required that this program be retroactively removed.

# Category #4: The Tax Ordinance Defines The Plan Document

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- The Tax Ordinance brings specificity to the concept of "plan document" by identifying those Board Rules that will be considered to be part of the plan document.
- The Tax Ordinance contains a high level of specificity with regard to compliance provisions.

# The Compliance Statement Identifies "Failures" and Corrections For The City, The Council, And SDCERS To Complete

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- Failures #1-3: Failure to Amend the Municipal Code to comply with federal law. These items are resolved by the Tax Ordinance.
- Failure #4: Incumbent Presidential Leave. Part of this item is resolved by the Tax Ordinance (repeal and replacement). SDCERS is required to recalculate the benefits of certain union presidents.
- Failure #5: Cashless Leave. Part of this item is resolved by the Tax Ordinance (repeal). SDCERS is required recalculate benefits of certain members.

# The Compliance Statement Identifies "Failures" and Corrections For The City, The Council, And SDCERS To Complete (Cont'd.)

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- Failures #6-7: Retiree Health Benefits. The Tax Ordinance partially addresses this failure. SDCERS has changes its procedures to implement the IRS correction.
- Failures # 8, 9, 10, 12: Failure to operate the plan in accordance with various Internal Revenue Code Sections. The Tax Ordinance partially addresses these failures. SDCERS has implemented new procedures to achieve compliance.
- Failure #11: Misinterpretation of Corbett Settlement. The correction of this failure has been implemented by a recalculation of benefits.

# The Compliance Statement Identifies "Failures" and Corrections For The City, The Council, And SDCERS To Complete (Cont'd.)

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- Failure #13: Domestic Partner Benefits. This failure is corrected by the Tax Ordinance. SDCERS had implemented this provision prior to the amendment.
  
- Failure #14: Annual City Contributions. This failure is corrected by the Tax Ordinance. SDCERS had implemented this provision prior to the amendment.

# Why Should the Council Act Now? What Is The Impact Of Disqualification?

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- Qualified plans have the most favorable tax treatment for employees, retirees, and survivors under the Internal Revenue Code.
- No other type of plan provides equivalent tax treatment.
- Qualified *governmental* plans have important tax provisions designed to address government rather than private sector employment.
- All of that would be lost upon disqualification.

# Maintaining Qualified Governmental Status Preserves Favorable Taxation of Employee Contributions

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- If SDCERS is qualified, employee contributions that are made to SDCERS are made on a pre-tax basis.
- If SDCERS is disqualified, these employee contributions would be treated as taxable.

# Maintaining Qualified Status Prevents Unexpected Taxation For Many Active And Retired Members

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- If SDCERS is a qualified plan, SDCERS members are taxed on their benefits when they receive them.
- If SDCERS is disqualified, SDCERS members would be taxed on their benefits when vested.
- Taxes would be due on benefits years before the benefits are payable to members and beneficiaries.

## Maintaining Qualified Status Avoids Immediate Taxation of Benefits— Example of an Active General Member

- If a vested general member still working today has a current benefit of \$2,000 per month, that member is not taxed under a qualified plan such as SDCERS until he or she actually draws a benefit.
- Under a disqualified plan, the active member will be taxed in the current year on the present value of \$2,000 per month for the member's anticipated lifetime. If the member is age 50 (and is assumed to retire at 55 with a 50% continuance), the member could be taxed now on the approximate present value - \$250,000.

## Maintaining Qualified Status Avoids Immediate Taxation of Benefits— Example of A Retired Member

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- If a retiree is receiving a \$3000 per month life annuity, the retiree is now just being taxed on the monthly payments actually made during the year.
- Under a disqualified plan, the retiree would be taxed this year on the value of future benefits. If the retiree is 60, the approximate present value is \$430,000.

# Maintaining Qualified Status Preserves The Rollover Option For Employees Who Withdraw Contributions

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- If SDCERS is a qualified plan, a SDCERS member who leaves employment and receives a refund of contributions can avoid immediate taxation by rolling that amount over to an IRA or to another retirement plan.
- If SDCERS is disqualified, that employee is immediately taxed and can't rollover.

# Maintaining Qualified Status Preserves The Rollover Option For DROP Members

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- If SDCERS is qualified, members with DROP accounts can elect to roll those over to an IRA or another plan at distribution.
- If SDCERS is disqualified, those refunds and DROP balances can't be rolled over and are immediately taxable to the individual.

# Preserving Qualified Status Protects The Tax Treatment Of Service Purchases

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- If SDCERS is qualified, the benefits attributable to service purchases are taxable when the benefits are paid.
- If SDCERS is disqualified, the value of those benefits is immediately taxable to members.

# How Would SDCERS Have To Proceed If The Technical Ordinance Is Not Adopted?

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- SDCERS would immediately notify the IRS that the Technical Ordinance was not adopted.
- SDCERS would immediately work with the IRS to determine a timeline to prepare reports and IRS filings to reflect the proper taxation of current employees and retirees.

# SDCERS's Position

□ "This was not a simple process. It's never easy to admit failures publicly. However, the Board has recognized that to regain the trust of our members and the public, we must face our past, recognize our mistakes and pledge to run this organization in accordance with all applicable laws."

— Tom Hebrank

□ The Council's approval of the Tax Ordinance is an important and necessary step to benefit SDCERS members and the public.

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March 27, 2008

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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WASHINGTON, D.C.

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4. The Port District and Airport Authority are required to amend their separate plans to comply with those portions of the VCP Agreement that are relevant to their plans.

#### Statement of Facts

On July 12, 2005, the SDCERS Board of Administration ("SDCERS Board") filed a Form 5300 Determination Letter application with the IRS seeking a favorable Determination Letter for SDCERS. On that same date, the SDCERS Board also filed a request for a Compliance Statement under the Voluntary Correction Program ("VCP") of the IRS' Employee Plans Compliance Resolution System. The VCP is a program that allows a plan to voluntarily disclose to the IRS, plan document or operational qualification failures it has discovered in its plan, propose corrections, negotiate those corrections with the IRS, and, ultimately, receive IRS approval of corrections and continued qualified status of the Plan, notwithstanding any past failures in operation. SDCERS' initial VCP filing concerned the "Presidential Leave" benefit under SDCERS that allowed the presidents of certain city employee labor unions to continue to participate in SDCERS while serving as union presidents, and to receive retirement benefits based on union compensation and union service. Between July 2005 and August 2006, SDCERS filed eight (8) supplemental VCP filings that identified other violations SDCERS' Board and their attorneys had discovered in SDCERS' operation and documentation. SDCERS and their legal counsel, Ice Miller LLP, had extensive discussions and negotiations with the IRS over the terms and conditions of the VCP Agreement. We understand that SDCERS vigorously attempted to get the IRS to agree to allow presidential benefits that had been recorded prior to the submission of the VCP, but notwithstanding their extensive efforts in this regard, the IRS refused to agree and insisted that, as a condition of reaching an agreement for general plan qualification, any SDCERS' benefits attributable to time as a union president and/or union compensation be deleted from the Plan.

On December 18, 2007, the IRS issued a Proposed Compliance Statement, resolving all of the SDCERS VCP submissions. The Compliance Statement was signed by the Board President, on behalf of the Board, and by you, as the City's Chief Operating Officer, on behalf of the City, on December 20, 2007. The SDCERS Board unanimously ratified the Compliance Statement (also referred to throughout this letter as "the VCP Agreement") on December 21, 2007. The signed VCP Agreement was submitted to the IRS which in turn, signed and dated it on January 10, 2008. The VCP Agreement requires that the City Council adopt plan amendments contained in an Ordinance which was negotiated with the IRS and approved by it, word-for-word, as part of the VCP Agreement. On January 25, 2008, the IRS issued SDCERS a favorable Determination Letter, confirming SDCERS' tax-qualified status. The favorable Determination Letter is contingent upon the City Council's adoption of all the Plan amendments contained in the Ordinance that was negotiated with the IRS, as part of the VCP Agreement, on, or before April 25, 2008. The VCP Agreement, and the Plan's continued qualified status is further contingent upon SDCERS implementing all of the changes contained in the attached Ordinance and set forth in the VCP Agreement, by no later than June 9, 2008.

Chief Operations Officer Jay Goldstone

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**Discussion of Specific Items of Correction**

The balance of this letter reviews each of the changes required by the VCP Agreement and contained in the Ordinance that will be presented to the City Council for its approval, discussing the background of the correction, the specific correction that is required, and, the impact of that correction.

**1. Technical Amendments:**

a. Background: The SDCERS Plan Document which is contained in the City Charter and Municipal Code, has not been amended to fully reflect a series of tax laws affecting pension plans that have been passed since the 1980's. As part of the plan of correction, the VCP Agreement requires the City to adopt technical amendments to the Municipal Code reflecting various tax law pension changes enacted between 1986 and 2001.

b. Correction: Amend the Municipal Code to comply with relevant pension tax laws enacted through the date of the Ordinance.

c. Impact: De Minimis, except as described for the other corrections. These technical amendments will not have any significant impact on the pension benefits, except, as described below, with respect to other specific corrections that involve bringing the Plan into compliance with particular provisions of applicable tax law.

**2. Presidential Leave:**

a. Background: The IRS has concluded that various union presidential leave pension accrual arrangements under SDCERS violated Code § 401(a), to the extent SDCERS based a pension on service with the union, compensation from the union, and/or accepted contributions from the union president and the union, based upon compensation from the union.

b. Correction:

i. Amend the Plan to retroactively remove Presidential Leave provisions that count service, with and/or compensation from the unions.

ii. Reduce pensions (annuity payments and DROP account balances, as applicable) of affected union presidents. This reduction will be effective retroactively for those union presidents who have already started receiving a pension. Also, SDCERS is required to collect past overpayments to union presidents affected by this retroactive change.

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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.

Chief Operations Officer Jay Goldstone

March 27, 2008

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b. Correction: SDCERS must reduce the pension annuity for two former City Managers whose compensation was in excess of the § 401(a)(17) limit. The IRS is not requiring that the third affected participant's pension be corrected because his excess benefit was only \$420.89, and it was paid out in 2002.

c. Impact: De Minimis.

i. The monthly annuities of the two affected former City Managers will be reduced by no more than \$1 or \$2 per month.

ii. Each affected former City Manager will receive a taxable refund of employee contributions, plus interest, that were based on the excess compensation.

#### 7. **Direct Rollover:**

a. Background: § 401(a)(31) of the Code requires pension plans to offer participants the opportunity to make direct rollovers of eligible rollover distributions from the pension plan. SDCERS failed to comply with this requirement from 2002 through 2006.

b. Correction: SDCERS must amend the Plan Document to provide for direct rollovers; and SDCERS must properly offer them to participants going forward.

c. Impact: De Minimis.

#### 8. **Disability Overpayments:**

a. Background: Between 2001 and 2006, SDCERS erroneously calculated disability benefits under the Plan by using a final compensation figure for the disabled participants that was increased by 10%. This 10% increase in final compensation was not provided for in the Plan Document. 146 participants received excess disability benefits because of this incorrect calculation methodology between 2001 and 2006, with total overpayments, plus interest, equaling \$1,221,543.

b. Correction:

i. Disability overpayments must be discontinued prospectively (they were actually discontinued starting in July 2006).

ii. The City's supplemental funding contributions to SDCERS in 2006 and 2007 were deemed by the IRS to be sufficient reimbursement to SDCERS for the past disability overpayments.

c. Impact: Moderate.

Chief Operations Officer Jay Goldstone

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- i. 146 participants have had their monthly payments reduced by 10%.
- ii. SDCERS has stopped increasing disabled participants' final salary by 10% when calculating disability benefits.

**9. Code § 415(b) Failure:**

a. Background: Code § 415(b) limits the amount of annual benefits that can be paid out of SDCERS to a participant. Code § 415(m) allows the City to set up a supplemental arrangement that pays out any excess annual benefits (but not DROP amounts) required by the SDCERS formula. These excess amounts cannot be paid out of the SDCERS trust fund, rather, the City will have to fund them in addition to its regular SDCERS pension funding contributions. Between 1996 and 2007, SDCERS improperly paid out annual benefits that exceeded the § 415(b) limit from the SDCERS trust fund. These excess trust payments involved 58 participants and the cumulative amount of these overpayments, plus interest, is approximately \$4,209,221. § 415(b) excess payments arose in three areas: (1) DROP, (2) Early Retirees and (3) Disability Benefits.

b. Correction:

i. SDCERS will no longer pay § 415(b) excess annual payments out of the SDCERS trust. In the future, the City will pay any § 415(b) excess annual payments out of its § 415(m) Plan.

ii. The IRS has concluded that the City adequately reimbursed the SDCERS trust for the past § 415(b) excess annual payments by having made its supplemental funding contributions in 2006 and 2007.

c. Impact: De Minimis.

i. None of the 58 affected participants will be adversely impacted. They will not have to repay any of the excess amounts previously received and none of their DROP accounts will be reduced.

ii. A § 415(m) Plan compliance mechanism is in place and has already been implemented by the City and SDCERS.

iii. Going forward, the IRS has allowed SDCERS to apply the available § 415(b) limit to DROP money first, so that any § 415(b) excess is applied to annual payments that can be paid out to participants under the § 415(m) program. This means that participants whose total SDCERS benefits exceed the § 415(b) limit, will still be able to roll over their DROP account into an IRA or eligible retirement plan.

Chief Operations Officer Jay Goldstone

March 27, 2008

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**10. Registered Domestic Partners.**

a. Background: SDCERS treated registered domestic partners as “spouses” for purposes of death benefits after California law was amended to require this result. However, the Plan Document was not amended to reflect this new State law legal requirement. The Code requires that SDCERS be administered in accordance with its Plan Document.

b. Correction:

i. The Plan Document must be amended to provide that registered domestic partners will be treated as “spouses” for purposes of SDCERS death benefits.

c. Impact: De Minimis.

i. This correction just conforms the Plan Document to actual practice and California legal requirements.

**11. City's Annual SDCERS Funding Contributions:**

a. Background: Currently, the Plan Document (SD Municipal Code § 24.0801) provides that the City's contribution to the SDCERS trust will be set by an MOU between the City and SDCERS Board. However, since July 26, 2004, the City has made higher contributions than called for in the MOU (which is dated November 18, 2002). We were informed by counsel for SDCERS that these higher payments were the result of a settlement in Gleason v. City of San Diego. The IRS has required that the Plan Document be amended to reflect the City's actual funding practices.

b. Correction: The IRS has required that the City amend the Plan Document to provide that the City's annual contribution will be set by the SDCERS Board based on “advice” from the Plan's actuary. This amendment must be effective July 26, 2004.

c. Impact: Minimal.

i. We understand that this change conforms the Plan Document to existing practice.

ii. We were informed that this change is not inconsistent with the Gleason settlement agreement, but have not separately investigated this agreement.

Chief Operations Officer Jay Goldstone

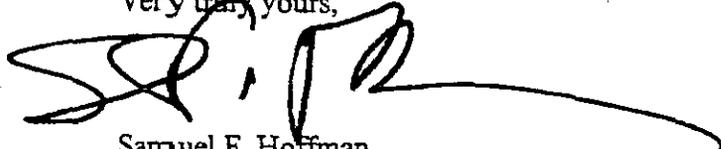
March 27, 2008

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Please give me a call so that we can set up a meeting to discuss these issues and the form in which this material should be presented to the City Council.

Very truly yours,

A handwritten signature in black ink, appearing to read 'S. F. Hoffman', with a long horizontal line extending to the right.

Samuel F. Hoffman

Cashless Leave Conversion List

Member Status	Annual Leave Hours Reduced	Original Cost of Time Purchased via Cashless Transfer	Creditable Service Purchase via Cashless Leave	Cost To Purchase Time at Current Salary	Difference b/t Cost to Purchase at Time of Leave Conversion and Current Salary (J-AA)	Pre Compliance Statement Benefit	Post Compliance Statement Benefit
Active	248.38	\$ 5,841.88	0.33467	\$9,831.13	(\$3,889.25)	N/A	N/A
Active	350.76	\$ 8,061.52	0.46328	\$13,029.89	(\$4,968.37)	N/A	N/A
Active	407.15	\$ 10,264.25	0.55928	\$18,305.41	(\$8,041.16)	N/A	N/A
Active	201.27	\$ 7,483.22	0.42147	\$12,380.95	(\$4,897.73)	N/A	N/A
Active	624.98	\$ 12,645.19	0.72121	\$24,764.35	(\$12,119.16)	N/A	N/A
Active	483.48	\$ 10,104.25	0.65155	\$19,395.97	(\$9,291.72)	N/A	N/A
Active	500.00	\$ 12,413.60	0.71339	\$20,084.01	(\$7,650.61)	N/A	N/A
Active	439.82	\$ 10,503.34	0.67729	\$21,190.89	(\$10,687.65)	N/A	N/A
Active	200.00	\$ 5,891.80	0.28026	\$9,199.36	(\$3,307.56)	N/A	N/A
Active	463.83	\$ 12,540.57	0.66260	\$20,333.15	(\$7,792.58)	N/A	N/A
Active	425.00	\$ 14,830.80	0.64516	\$22,153.02	(\$7,322.22)	N/A	N/A
Active	674.54	\$ 16,895.20	0.66361	\$27,421.86	(\$10,526.66)	N/A	N/A
Active	662.17	\$ 21,334.45	0.92808	\$36,899.82	(\$15,565.17)	N/A	N/A
Active	549.84	\$ 13,771.84	0.75049	\$21,357.07	(\$7,585.23)	N/A	N/A
Active	674.53	\$ 17,684.16	0.66358	\$28,684.65	(\$11,000.50)	N/A	N/A
Active	300.33	\$ 6,276.60	0.40473	\$12,048.37	(\$5,771.77)	N/A	N/A
Active	200.00	\$ 4,487.40	0.28265	\$7,315.18	(\$2,827.78)	N/A	N/A
Active	408.86	\$ 11,929.18	0.65000	N/A	N/A	N/A	N/A
Active	130.00	\$ 2,916.81	0.19022	\$5,328.88	(\$2,412.07)	N/A	N/A
Active	606.72	\$ 13,182.21	0.65003	\$20,583.81	(\$7,401.60)	N/A	N/A
Active	835.16	\$ 14,077.69	0.90777	\$27,023.33	(\$12,945.64)	N/A	N/A
Active	654.76	\$ 14,308.92	0.82231	\$24,045.27	(\$9,736.35)	N/A	N/A
Active	721.16	\$ 22,679.76	1.03066	\$38,508.76	(\$15,829.00)	N/A	N/A
Active	202.94	\$ 4,918.05	0.29003	\$7,670.38	(\$2,752.33)	N/A	N/A
Active DROP	207.70	\$ 12,090.43	0.50703	\$19,399.16	(\$7,308.73)	\$ 10,113.94	\$ 9,941.44
Active DROP	249.04	\$ 6,236.29	0.34446	\$8,725.71	(\$3,489.42)	\$ 4,824.17	\$ 4,769.80
Active DROP	249.96	\$ 8,604.95	0.33015	\$10,837.01	(\$4,032.06)	\$ 6,799.56	\$ 6,729.65
Active DROP	265.74	\$ 7,101.65	0.34456	\$12,351.87	(\$5,250.22)	\$ 7,645.49	\$ 7,565.04
Active DROP	360.53	\$ 10,011.92	0.48574	\$15,944.17	(\$5,932.25)	\$ 8,697.40	\$ 8,589.13
Active DROP	383.78	\$ 11,006.93	0.51710	\$17,520.99	(\$6,514.06)	\$ 7,277.58	\$ 7,038.77
Active DROP	473.83	\$ 14,133.24	0.68569	\$23,644.70	(\$9,411.46)	\$ 7,815.26	\$ 7,632.51
Active DROP	546.61	\$ 14,396.07	0.75089	\$23,338.01	(\$8,941.94)	\$ 6,512.90	\$ 6,355.88
Active DROP	692.39	\$ 17,451.22	0.83012	\$27,248.05	(\$9,796.83)	\$ 7,947.66	\$ 7,740.06
Active DROP	629.65	\$ 20,288.89	0.88254	\$31,639.30	(\$11,350.41)	\$ 7,815.44	\$ 7,592.90
Active DROP	662.91	\$ 21,079.87	0.64317	\$22,765.78	(\$1,685.91)	\$ 6,846.46	\$ 6,889.48
Active DROP	673.41	\$ 20,767.14	0.94374	\$30,977.52	(\$10,210.38)	\$ 7,048.34	\$ 6,823.36
Active DROP	200.00	\$ 6,083.80	0.28022	\$9,918.90	(\$3,835.10)	\$ 7,242.96	\$ 7,172.84
Active DROP	400.00	\$ 10,726.80	0.57171	\$22,225.72	(\$11,498.92)	\$ 7,701.89	\$ 7,548.51
Active DROP	671.22	\$ 22,780.53	0.95324	\$37,900.75	(\$15,120.22)	\$ 7,631.94	\$ 7,352.83
Active DROP	290.76	\$ 8,841.71	0.40726	\$13,799.15	(\$4,957.44)	N/A	N/A
Active DROP	713.08	\$ 15,726.24	0.89918	\$26,091.18	(\$10,364.94)	\$ 5,462.60	\$ 6,277.60
Retired DROP	260.86	\$ 7,101.65	0.35300	\$13,615.17	N/A	\$ 5,727.38	\$ 5,648.83

\$ 607,769.71 26,0041 \$ 815,278.52 \$ (313,024.48)

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TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

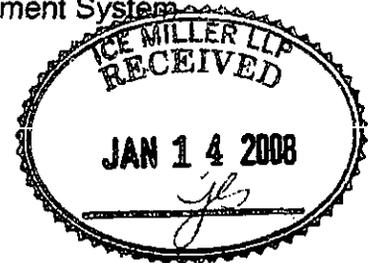
DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

January 10, 2008

Terry A.M. Mumford  
Ice Miller LLP  
One American Square-Suite 3100  
Indianapolis, IN 46282-0200

**Local contact address:**  
Internal Revenue Service  
SE:T:EP:RA:VC  
1111 Constitutional Ave. NW PE4G7  
Washington, DC 20224

Re: Compliance Statement for: San Diego City Employees' Retirement System  
Control Number: 911659038  
Employer Identification Number: 20-1800126  
Plan No.: 001



Dear Ms. Mumford:

The enclosed documents are sent to you under the provisions of a power of attorney currently on file with the Internal Revenue Service.

The determination letter associated with the above-referenced Voluntary Correction Program submission will be issued under separate cover.

If you have any questions, please contact Paul C. Hogan, ID# 91-07322 by phone at 206-220-6085 or by fax at 206-220-6071.

Sincerely,

A handwritten signature in cursive script that reads "Joyce Kahn".

Joyce Kahn  
Manager, EP Voluntary Compliance

Enclosures:

- Copy of Letter to Taxpayer
- Copy of signed Compliance Statement

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TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

January 10, 2008

Roxanne Story Parks, Chief Compliance Officer  
San Diego City Employees' Retirement System  
401 West A Street, Suite 400  
San Diego, CA 92101

Local contact address:  
Internal Revenue Service  
SE:T:EP:RA:VC  
1111 Constitutional Ave. NW PE4G7  
Washington, DC 20224

Re: Compliance statement for: San Diego City Employees' Retirement System  
Control Number: 911659038  
Employer Identification Number: 20-1800126  
Plan No.: 001

Dear Ms. Parks:

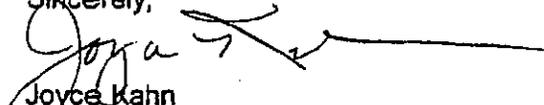
Enclosed is the compliance statement for the San Diego City Employees' Retirement System. A compliance statement constitutes an enforcement resolution solely with respect to certain failures of an employee retirement plan that is intended to satisfy the requirements of the Internal Revenue Code. It does not constitute a ruling letter within the meaning of Revenue Procedure 2008-4, 2008-1 I.R.B. 121, or a determination letter within the meaning of Revenue Procedure 2008-6, 2008-1 I.R.B. 192. The compliance statement should not be construed as affecting the rights of any party under any other law, including Title I of the Employee Retirement Income Security Act of 1974.

The determination letter associated with your related application that was part of your Voluntary Correction Program submission will be issued under separate cover.

At a later date, you may be required to verify that the correction of the failures and any modification of administrative procedures (upon which your enforcement resolution is conditioned) have been timely made.

Copies of this compliance statement and of this letter have been sent to your authorized representative in accordance with a power of attorney on file in this office. If you have any questions, please contact Paul C. Hogan, ID# 91-07322 by phone at 206-220-6085 or by fax at 206-220-6071.

Sincerely,

  
Joyce Kahn  
Manager, EP Voluntary Compliance

Enclosure(s):  
Compliance statement

cc: Mary Beth Braitman/Terry Mumford of Ice Miller LLP

000297

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.

## San Diego City Employees' Retirement System

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

## San Diego City Employees' Retirement System

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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San Diego City Employees' Retirement System

Failure #12

During the plan years that ended in 1996 through 2007 the Applicant did not comply with the provisions of the Code when it allowed the Plan to pay out benefits that exceeded the limits imposed by Code section 415(b). The Applicant represents that overpayments were made to approximately 58 participants and that the accumulated amount of overpayments plus interest associated with this failure is approximately \$4,209,221.

Failure #13

From January 1, 2005, through the present, the Applicant has allowed the Plan to provide spousal death benefits to registered domestic partners even though such benefits are not provided for under the terms of the Plan.

Failure #14

Starting on July 26, 2004, the Plan Sponsor has made contributions to the Plan that exceeded what was called for under the terms of the Plan section 24.0801 as set forth in the Memoranda of Understanding (November 18, 2002) between the Plan Sponsor and the Applicant. These payments resulted from the settlement of a class action court lawsuit (Gleason v. City of San Diego) involving the Plan Sponsor and the Applicant regarding the level of contributions that needed to be paid to the Plan.

II. APPLICANT'S CORRECTION

Failures #1 & 2

The Plan Sponsor and each participating employer will correct the qualification failure by adopting amendments in the form of a city ordinance that will allow the terms of the Plan to fully comply with all of the requirements of TRA '86, UCA, OBRA '93 and GUST retroactively to the effective dates of the specific provisions contained in the amendments. To assist in this matter, the proposed amendment will include draft Board rules that will be adopted by the Applicant.

Failure #3

The Plan Sponsor and each participating employer will correct the qualification failure by adopting interim amendments that satisfy the requirements of EGTRRA retroactively to the applicable effective dates of the specific provisions contained in the amendments.

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San Diego City Employees' Retirement System

Failure #4

The Plan Sponsor will amend the Plan retroactively to remove any provisions relating to Presidential Leave, including the Incumbent President Program. The resulting changes to the Plan will indicate that benefits and participation under the Plan are limited to employees of the Plan Sponsor and any other participating employers that have adopted the Plan and that retirement benefits would be based solely on paid compensation and service associated with the Plan Sponsor or other participating employers.

In regard to any employee contributions that were either paid to the Plan directly by the Unions or derived from compensation paid by the Unions such funds will be returned to the affected plan participants along with accumulated interest. The distribution of these monies will be a taxable distribution to each affected participant and such distribution will not be subject any favorable tax treatment under the Code. The Applicant will send a letter to each participant informing the participant 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 Form 1099-R for the calendar year in which the distribution is made to the affected participants. The Applicant will return to the Unions the employer contributions that were paid to the Plan to by the Unions.

For all impacted participants, 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 the Deferred Retirement Option Plan ("DROP"), will be determined without using any compensation paid by the Unions and any union service will also be disregarded in any computations unless such service has already been purchased by the participants under the Plan's regular service purchasing provisions. 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 affected participants via an offset against the return of employee contributions mentioned in the preceding paragraph, by direct repayment to the Plan by the affected participants or by a special actuarial reduction to the corrected monthly pension benefit on a going forward basis.

Failure #5

The Plan Sponsor will amend the Plan retroactively to remove any provisions relating to the Cashless Leave Conversion Program. This change will remove the impermissible cash or deferred arrangement from the Plan.

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San Diego City Employees' Retirement System

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

## San Diego City Employees' Retirement System

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).

## San Diego City Employees' Retirement System

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.

## San Diego City Employees' Retirement System

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.

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San Diego City Employees' Retirement System

**IV. APPLICANT'S PAYMENT**

The Plan Sponsor and Applicant will neither attempt to nor otherwise amortize, deduct, or recover from the Service any compliance fee paid in connection with this compliance statement, nor receive any Federal tax benefit on account of payment of such compliance fee.

**V. ENFORCEMENT RESOLUTION**

The Service will not pursue the sanction of plan disqualification on account of the qualification failure(s) described in Part I. The Service will waive the excise taxes under Code section 4974 on account of the qualification failure(s) described in Failure 8.

The Service will treat the amendment(s) described in Failure number 3 as if they had been timely adopted for the purpose of making available the extended remedial amendment period currently set forth in Revenue Procedure 2007-44, 2007-28 I.R.B. 54. However, this compliance statement does not constitute a determination as to whether any such plan amendment(s), as drafted, complies with the applicable change in qualification requirements.

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San Diego City Employees' Retirement System

This compliance statement considers only the acceptability of the correction method(s) and the revision(s) to administrative procedures described in the submission and does not express an opinion as to the accuracy or acceptability of any calculations or other material submitted with the application. In no event may this compliance statement be relied on for the purpose of concluding that the Plan or Plan Sponsor (as defined in the applicable revenue procedure setting forth the Employee Plans Compliance Resolution System) was not a party to an abusive tax avoidance transaction. The compliance statement should not be construed as affecting the rights of any party under any other law, including Title I of the Employee Retirement Income Security Act of 1974.

This compliance statement is conditioned on (1) there being no misstatement or omission of material facts in connection with the submission, and (2) the completion of all corrections described in Parts II and III within one hundred fifty (150) days of the date of the compliance statement.

By signing this compliance statement, the Plan Sponsor and Applicant hereby agree to its terms.

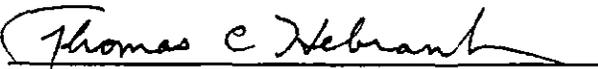
The City of San Diego

By: 

Title: COO

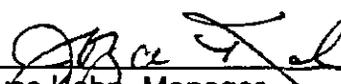
Date: 12/20/07

Board of Administration For The San Diego City Employees' Retirement System

By: 

Title: President, Board of Administration

Date: 12/20/07

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**EXHIBIT 2 -- REVISED**

**SAN DIEGO CITY EMPLOYEES  
RETIREMENT SYSTEM**

**415(b), (c), and (n) Compliance Strategy Report**

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**I.**  
**INTRODUCTION**

Ice Miller LLP ("Ice Miller") has been retained to provide a compliance review with regard to the Internal Revenue Code of 1986, as amended ("Code"), requirements applicable to the status of the San Diego City Employees' Retirement System ("SDCERS") as a qualified retirement plan under Code Section 401(a).

Ice Miller is not considering tax reporting and withholding under the Code nor any other federal law. We are also not deliberating any state law issues. Where state law must be considered, we are relying on interpretations provided by SDCERS counsel.

This report pertains to Code Section 415(b) and 415(c), and to Code Section 415(n) as it is related to 415(b) and 415(c). We have touched on Code Section 415(m) only with respect to the treatment of excess benefits under Code Section 415(b). We have prepared a separate briefing document for SDCERS on the topic of 415(m).

We have based this report on the material provided to us by SDCERS. We have not independently verified what has been provided to us. We are relying on SDCERS to provide us with documents, forms, and information necessary for this review.

This report was issued as part of the VCP supplement that was submitted to the IRS on August 9, 2006. In response to comments and questions by the IRS, this report has been revised. In addition, this report has been updated to reflect changes made by the Pension Protection Act of 2006 ("PPA") and the Final Regulations issued under Code Section 415 on April 5, 2007.

Based upon a meeting with the IRS on November 19, 2007, the document was revised to incorporate requested changes and to provide examples of certain calculations. This document was further revised pursuant to a conference call with the IRS on December 5, 2007.

**II.**  
**IMPORTANCE OF CODE SECTION 415 COMPLIANCE**

**A. SDCERS AS A QUALIFIED GOVERNMENTAL PLAN**

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.

**B. CODE SECTION 415 LIMITS**

One key qualification requirement applicable to qualified plans is the Code Section 415 limits. Code Section 415 benefit and contribution limits must be followed to protect the tax

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qualified status of a retirement plan under Code Section 401(a). These limits must be met by all plan members. 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. However, the EPCRS program found in Revenue Procedure 2006-27 provides mechanisms for correction to avoid this result.

### C. FINAL REGULATIONS

Final Regulations under Code Section 415 were issued by the IRS April 5, 2007. The Final Regulations are effective for governmental plans for all limitation years that begin more than 90 days after the close of the first regular legislative session of the legislative body with authority to amend the plan that begins on or after July 1, 2007. However, a governmental plan may apply the provisions of the Final Regulations as early as the limitation year beginning on or after July 1, 2007.

For SDCERS, the Final Regulations would be applicable to the first limitation year that begins in 2008 – or the July 1, 2008 limitation year. As discussed within, SDCERS will move to a calendar year limitation year as of January 1, 2009, assuming an ordinance amendment is adopted.

## III. OVERVIEW OF LAW WITH RESPECT TO DEFINED BENEFIT LIMITATIONS

This Section of our Compliance Strategy Report provides an overview of the federal law with regard to Code Section 415(b). The impact of Code Section 415(b) on SDCERS and our specific recommendations for a compliance strategy are included in the next Section of this Report.

### A. BASIC BENEFIT LIMITS

#### 1. Current Limits

As amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the basic requirement of Code Section 415(b) is that the annual benefit in the form of a single life annuity provided to a member who is between the ages of 62 and 65 may not exceed the lesser of: (1) \$160,000 as adjusted for inflation in \$5,000 increments (the "Dollar Limit"), or (2) 100% of average compensation (the "Salary Limit"). Code Section 415(b)(1). The Salary Limit does not apply to governmental plans such as SDCERS. Therefore, the following discussion and our methodology do not include the Salary Limit.

#### 2. Limitation Year

The annual benefit is tested in a "limitation year." Unless an election is made by the employer, the limitation year is the calendar year. Treas. Reg. § 1.415(j)-1. An employer that maintains more than one qualified plan may elect to use different limitation years for each such plan. Treas. Reg. § 1.415(j)-1(c).

Retrospectively, the IRS is requiring that SDCERS use a July 1 fiscal year for testing. The analysis of 415(b) limits in the context of the Fiscal Year is summarized in the following regulatory provision:

The adjusted dollar limitation applicable to defined benefit plans and the adjusted compensation limit applicable to a participant are effective as of January 1 of each calendar year and apply with respect to limitation years ending with or within that calendar year. However, benefit payments (and, in the case of plans that are subject to the requirements of section 411, accrued benefits for a limitation year) cannot exceed the currently applicable dollar limitation or compensation limitation (as in effect before the January 1 adjustment) prior to January 1. Thus, where there is an increase in the limitation under section 415(b)(1), any increase in a participant's benefits associated with the limitation increase is permitted to occur as of a date no earlier than January 1 of the calendar year for which the increase in the limitation is effective, and can only be applied for payments due on or after January 1 of such calendar year. For example, assume that a participant in a defined benefit plan is currently receiving a benefit in the form of a straight life annuity, payable monthly, in an amount equal to the section 415(b)(1)(A) dollar limit, and the defined benefit plan has a limitation year that runs from July 1 to June 30. If the plan is amended to reflect the section 415(d) increase to the section 415(b)(1)(A) dollar limit that is effective as of January 1, 2009, the associated increase in the participant's monthly benefit payments is only effective for payments due on or after January 1, 2009, and the participant's benefit cannot be increased to reflect the section 415(d) increase that is effective January 1, 2009, with respect to any monthly payment due prior to January 1, 2009.

Treas. Reg. § 1.415(d)-1(a)(3) (emphasis added). Applying this regulation to the SDCERS situation, we come up with the following example:

As of July 1, 2005, the limitation on the annual benefit is \$170,000, but assume that the member's annual benefit for the Fiscal Year would be \$175,000 under the applicable formula. (For purposes of this example we are assuming a single straight life annuity with no after-tax contributions and no rollovers to consider.) The monthly benefit that is paid from July 1, 2005, through December 31, 2005 cannot exceed 1/12 of \$170,000. However, starting January 1, 2006, when the annual limit goes to \$175,000, the monthly benefit can increase so it is 1/12 of \$175,000.

Prospectively, as of January 1, 2009, SDCERS will move to a calendar year for 415 testing, assuming a technical ordinance is adopted to amend the San Diego Municipal Code.

## B. TAMRA ELECTION

Section 415(b)(10) of the Code was added by the Technical and Miscellaneous Revenue Act of 1988 (sometimes called TAMRA) to offer state and local government plans a means of complying with the Section 415 limits without violating state anti-cutback laws. Under this Section, the defined benefit limit for an employee who became a participant in the plan before January 1, 1990, would not be less than his or her accrued benefit determined without regard to

any plan amendment adopted after October 14, 1987. However, for a state or local government to take advantage of Section 415(b)(10), each employer maintaining the plan was required to elect, before the close of the plan year beginning in 1990, to apply the defined benefit limits applicable to private plans to employees who first became participants after 1990. However, there were also special provisions for state-wide statutory changes. For plans that made a TAMRA election, the qualified participants would still have their TAMRA protection. Revocation of a TAMRA election is permitted pursuant to Code Section 415(b)(10)(C)(ii), effective for all plan years to which the election applied and to all subsequent plan years, provided the revocation is accomplished by the last day of the third plan year beginning after August 20, 1996.

### C. AMOUNTS EXCLUDED FROM TESTING

For purposes of Code Section 415(b), the annual benefit means the benefit payable annually in the form of a straight life annuity (with no ancillary benefits), without considering payments made from a qualified excess benefit arrangement, after-tax employee contributions, and any rollover contributions. Code Section 415(b)(2).

#### 1. Ancillary Benefits

"Ancillary benefits" do not count toward the benefits subject to Code Section 415. As a result, any benefit that is an ancillary benefit can exceed the 415 limits without the plan being disqualified. Generally, "ancillary benefits" are benefits not directly related to retirement income benefits. Ancillary benefits include "pre-retirement disability benefits and death benefits (such as in-service death benefits)." Code Section 415(b)(2)(B); Treas. Reg. § 1.415(b)-1(c)(4).

##### *a. Disability Benefits*

All Disability benefits must be taken into account for purposes of complying with the Code Section 415 limitations, subject to the special rule under Code Section 415(b)(2)(I).

##### *b. Pre-Retirement Death Benefits*

Pre-retirement death benefits provided under a governmental plan are also exempt from the Code Section 415 limits. Treas. Reg. § 1.415(b)-1(c)(4)(i)(B). The Final Regulations make it very clear that pre-retirement death benefits must meet the incidental benefit requirements of Code Section 401 and the regulations thereto in order to be excluded from 415(b) testing. Generally speaking, death benefits are incidental where the plan provides a pre-retirement death benefit that is no greater than 100 times the monthly annuity benefit provided under the plan, or the cost of the death benefit does not exceed 25% of the total cost of all benefits for that

participant. (This latter test would be one that would be analyzed by an actuary.) Revenue Ruling 74-307, 1974-2 C.B. 126.

## 2. Pre-1995 Payments

Effective for years after December 31, 1994, state and local government employers may maintain "qualified governmental excess benefit plans" ("QEBA") under Code Section 415(m). Excess Plans are plans that provide benefits that cannot be provided under a qualified plan due to the limits on contributions and benefits. As we have discussed, we will not be addressing Code Section 415(m) and QEBAs in this report, but in a separate report. From the IRS viewpoint, the QEBA is not considered to be part of the correction for the 415 VCP. However, for the purposes of determining retrospective benefit testing protocols, we think that it is relevant to consider the following provisions that accompanied the enactment of Code Section 415(m):

Nothing in the amendments made by this section shall be construed to imply that a governmental plan (as defined in section 414(d) of the Internal Revenue Code of 1986) fails to satisfy the requirements of section 415 of such Code for any taxable year beginning before January 1, 1995.

P.L. 104-188, § 1444(c)(2). Under this grandfather section, retroactive testing for plan qualification purposes does not need to consider payments made prior to January 1, 1995.

## 3. Allocation of Benefits to After-Tax Employee Contributions

Treasury Regulation § 1.415(b)-1(b)(1)(ii) provides that the benefit attributable to "Employee Contributions" is not included in the benefit which is tested against the 415(b) limitation. In general, this is because these contributions are deemed to be annual additions and subject to Code Section 415(c) limits (discussed below in more detail). Therefore, because the benefits have already been tested under Code Section 415(c), any portion of a defined benefit attributable to those after-tax contributions may be subtracted from the annual benefit before it is tested under Code Section 415(b). However, it is important to note that benefits that would be attributable to excess 415(c) contributions would not be "subtracted" from the annual benefit for 415(b) testing purposes.

### *a. Definition of Employee Contributions*

Only certain employee contributions are treated as Employee Contributions for purposes of 415(b) testing. In particular, the following items are not treated as Employee Contributions and therefore the benefit attributable to these items is included for purposes of 415(b) testing:

- Contributions picked up by the employer pursuant to Code Section 414(h).
- Any repayment of a loan from the plan to the participant.
- Certain repayments amounts previously distributed upon the participant's termination of participation in the plan.

- Certain repayments of a withdrawal of employee contributions.

***b. Mandatory Employee Contributions***

Treasury Regulation § 1.415(b)-1(b)(2)(iii) provides that the annual benefit attributable to mandatory contributions is determined by using the factors described in Code Section 411(c)(2)(B) "regardless of whether the requirements of sections 411 and 417 apply to that plan." Treasury Regulation § 1.411(c)-1(c) establishes the required method for allocating a portion of the defined benefit to the after-tax employee contributions for purposes of excluding this amount from the final annual benefit to be tested. The method requires calculation of the after-tax (not picked up) employee contributions (both mandatory employee contributions and any voluntary after-tax payments for service purchases unless tested under Code Section 415(n)), plus interest, at rates specified by the regulations. See Treas. Reg. § 1.411(c)-1(c). Generally, interest is computed at the rate provided by the plan until the last plan year before Code Section 411(a)(2) does not apply. Id. Thereafter, a plan should use a 5% interest rate factor.

In general, Code Section 411(a)(2) does not apply to a governmental plan, such as SDCERS. However, the Final Regulations provide that Code Section 411 should be treated as applicable to this calculation even if the section is not applicable to the plan. The Explanation of Provisions in the Final Regulations states that a plan not subject to Code Section 411(a)(2), such as a governmental plan, should determine what the effective date of Code Section 411(a)(2) would have been if 411 applied to the plan and then apply the specific interest rates appropriately. Therefore, only the benefit attributable to employer contributions using 411 factors can be excluded from 415(b) testing.

Treasury Regulation § 1.415(b)-1(b)(2)(iii) clearly indicates that the Code Section 411 factors should be applied to a governmental plan for purposes of determining the benefit attributable to employee contributions for purposes of Code Section 415(b) testing. The calculation is done in a two-step process. First interest is accumulated on the contributions using the applicable interest rates specified in Code Section 411(c). The 411 interest rates are the following:

- for contributions prior to 1976, use the interest rate in the plan document, if any;
- for contributions between 1976-1987, use 5%;
- for contributions from 1988 through the date the benefit commences or the annuity starting date (the determination date), use 120% of the mid-term applicable federal rate; and
- for contributions from the determination date to the normal retirement date (the date at which unreduced benefits are paid), use the applicable 417(e) interest rate.
- For plan years beginning before January 1, 2008, the applicable 417(e) rate is the annual rate on 30-year Treasury securities for the month before the distribution.

- For plan years beginning on and after January 1, 2008, the applicable 417(e) rate is the adjusted first, second and third segment rates for the month before the distribution. The segment rates are based on the corporate bond yield curve based on varying maturities. The IRS announces all rates monthly.

The second step is for the accumulated value of the contributions with interest to be converted to an annuity value using the applicable 417(e) interest rate and the applicable 417(e) mortality table.

SDCERS must determine what the effective date of Code Section 411(a)(2) would have been, had that provision applied to SDCERS, and then apply the appropriate 411 factors from that date forward in order to determine the benefit attributable to after-tax employee contributions. For that purpose, the vesting rules of Code Section 411(a)(2) were generally applicable to plan years beginning after September 1, 1976. However, for a plan in existence on January 1, 1974, Code Section 411(a)(2) was applicable for plan years beginning after 1975.

As noted above, this would be the same approach that would be followed in testing the benefit attributable to rollovers and transfers that are used to purchase service.

We have taken the position that prior to the issuance of the Final Regulations, the use of the 411 factors should not have been applicable to SDCERS for two reasons – first, Code Section 411 is not applicable to governmental plans and secondly, because prior to the issuance of the Final Regulations IRS guidance clearly stated that 417(e) factors were not to be used for governmental plans for 415 testing. Revenue Ruling 98-1, Q&A-3. Therefore, given the interplay between 411 and 417(e), it seems that the 411 factors should not apply to a governmental plan until 417(e) was made applicable to a governmental plan.

- Exhibit A and the accompanying examples explain how the benefit attributable to employee contributions was determined by Cheiron for retrospective testing purposes (prior to July 1, 2008).
- Exhibit B explains how the benefit attributable to employee contributions will be determined by Cheiron for prospective testing purposes (on and after July 1, 2008).

#### *c. Voluntary After-Tax Contributions*

Where a plan permits voluntary after-tax employee contributions, the portion of the plan to which such contributions are made is treated as a defined contribution plan. Therefore, voluntary after-tax contributions are subject to the 415(c) contribution limits and not the 415(b) benefit limits. Treas. Reg. § 1.415(b)-1(b)(2)(iv). The benefit attributable to voluntary after-tax contributions is not subject to 415(b) testing. However, that calculation is done using 411 factors as above.

#### **4. Employee After-Tax Contributions for Permissive Service Credit**

Code Section 415(n) establishes a limitation structure for "permissive service credit" purchases, instead of relying on the existing Code Section 415(c) defined contribution

limitations. This subsection allows Code Section 415 to be satisfied by a purchase of permissive service credit if either a modified 415(b) limit is met or a modified 415(c) limit is met. These limits can be applied on a participant-by-participant basis rather than choosing to apply the limit on a plan-wide basis. For example, some participants could satisfy the modified defined benefit limit when making a purchase of permissive service credit, while others could satisfy the modified defined contribution limit.

*a. Modified 415(b) Limit*

For purposes of Code Section 415(n), the defined benefit limit in Code Section 415(b) may be met by treating the accrued benefit derived from all permissive service credit as part of the member's annual benefit. Code Section 415(n)(2)(A) provides that, where the dollar limit under 415(b) is reduced for retirement before age 62, "the plan shall not fail to meet the reduced dollar limit under Subsection (b)(2)(C) [the age-reduced dollar limit] solely by reason of this subsection." Thus, the plan will not fail to meet the age-reduced dollar limit solely because the accrued benefit derived from the permissive service credit purchase is included in the 415(b) test.

*b. Modified 415(c) Limit*

For purposes of Code Section, only the dollar limit under Code Section 415(c) applies (\$40,000 (adjusted for inflation)) by treating all permissive service contributions as an annual addition under that limit.

*c. Definition of Permissive Service Credit*

The special testing rules apply only if the service being purchased qualifies as permissive service credit. Code Section 415(n)(3) defines "permissive service credit" as follows:

(3) PERMISSIVE SERVICE CREDIT.—For purposes of this subsection—

(A) IN GENERAL.—The term "permissive service credit" means service credit—

(i) recognized by the governmental plan for purposes of calculating a participant's benefit under the plan,

(ii) which such participant has not received under such governmental plan, and

(iii) which such participant may receive only by making a voluntary additional contribution, in an amount determined under such governmental plan, which does not exceed the amount necessary to fund the benefit attributable to such service credit.

Such term may include service credit for periods for which there is no performance of service, and, notwithstanding clause (ii), may include service credited in order to provide an increased benefit for service credit which a participant is receiving under the plan.

Code Section 415(n)(3)(A). The proper interpretation of the Code Section 415(n) definition of permissive service credit is not a settled term. The Final Regulations do not address 415(n) issues. However, the PPA did clarify that benefit enhancement purchases (buying a higher multiplier on service a member already has in a plan) or airtime purchases (buying service credit for a period for which there is no performance of service) both qualify as permissive service credit.

*d. Nonqualified and Qualified Permissive Service*

Permissive service credit can be categorized into two types. First, the Code defines "non-qualified service credit" as all permissive service credit that does not fall within one of the itemized types listed in Code Section 415(n)(3)(C). Although the Code does not use this term, we have termed the types of service included in this list as "qualified permissive service."

Code Section 415(n)(3)(C) defines "nonqualified service" as all permissive service except for the following types of service (which we have designated "qualified permissive service"):

- Service (including parental, medical, sabbatical, and similar leave) for the US government, any state or political subdivision thereof, or any agency or instrumentality of any of the foregoing.
- Service (including parental, medical, sabbatical, and similar leave) for an educational organization which is a public, private, or sectarian school which provides elementary or secondary education (through grade 12) as determined under state laws.
- Service for an association of employees of the U.S., state or political subdivision thereof, or an agency or instrumentality of the foregoing.
- Military service (non-USERRA covered) recognized by the governmental plan.

However, service under the first three (3) points above will be nonqualified service if recognition of the service would cause the member to receive a retirement benefit for the same service under more than one plan. Code Section 415(n) does not permit a plan to take more than five (5) years of nonqualified service into account, or to give members credit for any nonqualified service before the member has at least five (5) years of participation in the plan. Code Section 415(n)(3)(B). The PPA clarified that these limits do not apply to trustee-to-trustee transfers from a 457(b) plan or a 403(b) plan for the purchase of permissive service credit.

It is important to note that "nonqualified service" is still one type of permissive service that is described in Section 415(n)(3)(A). Therefore, nonqualified service is available for purchase and may be tested under Code Section 415(n) special testing provisions.

*e. Effective Dates*

The service purchase testing provisions for permissive service credit under Code Section 415(n) are subject to a transition rule. The transition rule provides that the defined contribution limits of Code Section 415(c) will not be used to reduce the amount of permissive service credit

an "eligible participant" can purchase below what they were allowed to purchase under the terms of the plan as in effect on the enactment date, August 5, 1997. An "eligible participant" is an individual who first becomes a participant in the plan before the first plan year beginning after the last day of the calendar year in which the next regular session (following the date of enactment) of the governing body with authority to amend the plan ends.

Because the term "permissive service" is used in the grandfather provision, we believe that the IRS would apply a consistent definition of permissive service credit to the transition rule. As a result, the transition provision could permit greater purchases of nonqualified service and could permit permissive service purchases that exceed 415(c) and (b) limits, but would not extend to the purchase of service that did not meet the definition of permissive service credit.

#### **5. Picked-Up Contributions**

It is important to note that pre-tax contributions ("picked-up contributions"), whether mandatory or voluntary, are not treated as post-tax contributions. The benefit attributable to picked-up contributions is subject to 415(b) testing. Treas. Reg. § 1.415(b)-1(b)(2)(ii)(A).

Pursuant to Revenue Ruling 2006-43, SDCERS will not allow multiple pick-up elections.

#### **6. Amounts Attributable to Rollovers**

Rollovers to a defined benefit plan are treated similarly to employee contributions for purposes of 415(b) testing:

If the benefit under the plan is payable in any form other than the form described in subparagraph (A), or if the employees contribute to the plan or make rollover contributions (as defined in sections 402(c), 403(a)(4), 403(b)(8), 408(d)(3), and 457(e)(16), the determinations as to whether the limitation described in paragraph (1) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by adjusting such benefit so that it is equivalent to the benefit described in subparagraph (A).

Code Section 415(b)(2)(B). The Final Regulations treat rollovers in a manner similar to after-tax contributions, so that the benefit attributable to the rollover must be converted in accordance with prescribed 411 factors. This is true only to the extent the plan provides for a benefit based upon the rollover contributions. That is, if the benefit attributable to the rollover contributions is based upon a separate account, in which the rollover contributions are credited with actual earnings and losses, then the separate account is treated as a defined contribution plan. Treas. Reg. § 1.415(b)-1(b)(2)(v).

#### **7. Amounts Attributable to Transfers between Qualified Plans**

Under the Final Regulations, the treatment of transferred benefits for purposes of the 415(b) limits depends upon the types of plans involved and whether there is any relationship between them. Where the transfer is from one defined benefit plan to another defined benefit plan, the receiving plan must include the transferred benefits for purposes of applying the 415(b) limitations. Treas. Reg. § 1.415(b)-1(b)(3)(i)(C).

Where the transfer occurs between two plans which must be aggregated, the transferred benefits must be included by the receiving plan for 415(b) testing purposes. Where the transfer occurs between two plans which are not aggregated, the transferor plan is required to include the transferred benefits by treating the benefits as if provided as an annuity from a separate plan which must be aggregated with the transferor plan. Treas. Reg. § 1.415(b)-1(b)(3)(i)(A), (B).

**8. Plan-to-Plan Transfers from a 457(b) or 403(b) Plan**

Amounts accepted in a plan to plan transfer from a 457(b) or 403(b) plan should be treated in the same manner as a rollover, as discussed above.

**9. Restoration of Contributions**

Code Section 415(k)(3) provides that any repayment of contributions (including interest) will not be taken into account for Code Section 415 purposes if the repayment is to a governmental plan with respect to an amount previously refunded on a forfeiture of service credit under that plan or any other governmental plan maintained by the state or any local governmental employer within the same state. Thus, so long as the amount repaid does not exceed the amount refunded, plus interest, Code Section 415 should not apply. However, the Final Regulations do provide that the restored benefit is to be treated for testing purposes as the original benefit would have been treated.

**D. AGE-BASED ADJUSTMENT TO LIMITS**

**1. Benefits Before Age 62**

When the benefit begins before the participant reaches age 62, the Dollar Limit benefit limit generally must be actuarially adjusted so that the limit (as reduced) equals an annual benefit that is payable when the retirement benefit begins, and which is the equivalent of the Dollar Limit beginning at age 62. Code Section 415(b)(2)(C). The actuarial adjustments must be made in accordance with Code Section 415(b)(2)(E). Treas. Reg. § 1.415(b)-1(d). Pre-EGTRRA, Code Section 415(b)(2)(F) limited the actuarial reduction for governmental plans to a \$75,000 benefit payable at age 55 or, if the benefit began before age 55, the actuarial equivalent of a \$75,000 benefit beginning at age 55.

***a. Exception for Public Safety and Military***

However, no age-based actuarial reduction is required for benefits beginning prior to age 62 for qualified participants. A qualified participant is defined as a participant:

- (i) in a defined benefit plan which is maintained by a State, Indian tribal government (as defined in section 7701(a)(40)); or any political subdivision of a state or Indian tribal government,
- (ii) with respect to whom the period of service taken into account in determining the amount of the benefit under such defined benefit plan includes at least 15 years of service of the participant –

(I) as a full-time employee of any police department or fire department which is organized and operated by the State, Indian tribal government, or political subdivision maintaining such defined benefit plan to provide police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State, Indian tribal government, or political subdivision, or

(II) as a member of the Armed Forces of the United States.

Treas. Reg. § 1.415(b)-1(d)(3). Historically, there has been some concern over the interpretation of the statutory provision. For example, it was not entirely clear whether the qualified participant had to be a sworn officer of a police department or whether any employee of a police department would be covered by this provision. However, the Final Regulations offer some clarification, making it clear that the application of the rule depends on whether the employer is a police department or fire department of the state or political subdivision, rather than on the job classification of the individual participant.

This exception is very beneficial to public safety officers and to other employees of police and fire departments, including non-public safety personnel. However, this definition does not cover all public safety employees. The examples in the Final Regulations make it clear that an employee of a police division of an agency may be a qualified participant, but that an ambulance driver who works for an emergency medical services agency rather than a police or fire department cannot. While the name of the agency is not important, it is necessary that the employer (or at least the appropriate division of the employer) function as a police or fire department. Also, it is helpful to note that the examples in the Final Regulations do make it clear that the 15 years can be satisfied with a combination of police/fire service and military service.

***b. Exception for Disability and Death Benefits***

In addition, the actuarial reduction for benefits beginning before age 62 does not apply to disability benefits or survivor benefits payable in the event of the disability or death of the member provided under a governmental plan. Code Section 415(b)(2)(I). The benefit must be paid "on account of the participant's becoming disabled by reason of personal injuries or sickness, or as a result of the death of the participant." Treas. Reg. § 1.415(b)-1(d)(4). This provision will mitigate the IRS position that post-retirement disability benefits must be tested under 415(b).

***c. Exception for Permissive Service Credit Procedures***

A purchase of permissive service credit may be tested under Code Section 415(b) without regard to the reduction for early retirement.

**2. Benefits After Age 65**

For all members, if the retirement benefit under the plan begins after age 65 and is actuarially increased due to the delayed starting date, the Dollar Limit is increased so that it is the actuarial equivalent of an annual benefit beginning at age 65. Code Section 415(b)(2)(D). The actuarial assumptions used to make this conversion are set forth in Code Section 415(b)(2)(E).

However, under the Final Regulations, this adjustment in the Dollar Limit is only available where the benefit is also increased post age 65

#### E. ADDITIONAL SPECIAL RULES

Code Section 415(b) has a number of additional special rules that may impact governmental employers.

##### 1. Small Benefits

Code Section 415(b)(4) provides that defined benefit limits will not be applied to reduce a participant's benefits when total annual distributions are \$10,000 or less. However, this limitation only applies "if the employer has not at any time maintained a defined contribution plan in which the employee has participated." Code Section 415(b)(4)(B); Treas. Reg. § 1.415(b)-1(f). The \$10,000 test is measured against actual distributions – not the actuarial equivalent of a straight life annuity.

##### 2. Less than 10 Years of Participation

When an employee has less than ten years of participation in a defined benefit plan, the basic Code Section 415(b) Dollar Limit (or the minimum \$10,000 exemption from testing) is reduced by 10% for each year less than ten in which the employee participated in the defined benefit plan for other than death and disability benefits (but not below 1/10<sup>th</sup> of the Dollar Limit). Code Section 415(b)(5) and Treas. Reg. § 1.415(b)-1(g).

#### F. OPTIONAL FORMS OF BENEFITS – BENEFITS OTHER THAN A STRAIGHT LIFE ANNUITY

Benefits in a form other than a straight life annuity must be actuarially adjusted to a straight life annuity beginning at the same age in accordance with the otherwise applicable rules. For example, annuity benefit forms including a post-retirement death benefit or an annuity providing for a guaranteed number of payments must be adjusted for purposes of applying the Code Section 415(b) limit. See Treas. Reg. § 1.415(b)-1(c).

##### 1. 417(e)(3) Benefits and Non-417(e)(3) Benefits

Code Section 415(b)(2)(E)(i) provides that "for purposes of adjusting any limit under subparagraph (C) [adjustment to dollar limit before age 62] and ... for purposes of adjusting any benefit under subparagraph (B) [adjustment for other forms of benefits], the interest rate assumption shall not be less than the greater of 5% or the rate specified in the plan." With respect to adjusting a different form of benefit (under Code Section 415(b)(2)(B)), different interest rate assumptions are used in the case of a form of benefit subject to Code Section 417(e)(3). Code Section 415(b)(2)(E)(ii). However, prior to the Final Regulations, because a governmental plan is not subject to Code Section 417(e)(3), these different interest rate assumptions were not considered to be applicable to governmental plans. Rev. Rul. 98-1, Q&A-3, concluded that plans that are not subject to Code Section 417(e)(3), such as governmental plans, were not subject to the interest rate requirement under Section 415(b)(2)(E)(ii).

However, with the Final Regulations this position has been changed for governmental plans on and after the effective date. The Explanation of Provisions to the Final Regulations states that because Code Section 415(b)(2)(E) applies based on the form of the benefit rather than the status of the plan, the rules set forth in Treasury Regulations § 1.415(b)-1(b)(c) that dictate the manner of adjusting forms of benefit to which 415(e)(3) does or does not apply must be used regardless of whether Code Section 417(e)(3) otherwise applies to the plan. Thus, a governmental plan must follow these rules, presumably as if 417(e)(3) applied.

Code Section 417(e)(3) generally applies to full and partial lump sum distributions and period certain annuities. In a governmental plan, this may include DROP distributions and level income options which do not qualify as Social Security options. Treasury Regulation § 1.415(b)-1(c)(2) provides that if 417(e)(3) does apply to the form of benefit, then the actuarially equivalent straight life benefit is the greatest of:

- The annual amount of a straight life annuity beginning on the same date as the form of benefit actually being paid and which has the same actuarial present value as the benefit being paid, computed using the interest rate and mortality table (or tabular factor) specified by the plan;
- The annual amount of a straight life annuity beginning on the same date as the form of benefit actually being paid and which has the same actuarial present value as the benefit being paid, computed using a 5.5% interest rate and the appropriate mortality table from Treasury Regulation § 1.417(e)-1(d)(2) for that starting date; or
- The annual amount of a straight life annuity beginning on the same date as the form of benefit actually being paid and which has the same actuarial present value as the benefit being paid, computed using the interest rate specified in Treasury Regulation § 1.417(e)-1(d)(3) and the appropriate mortality table from Treasury Regulation § 1.417(e)-1(d)(2), divided by 1.05.

Code Section 417(e)(3) does not apply to straight-life annuities or qualified joint and survivor annuities. If 417(e)(3) does not apply to the form of benefit, then the actuarially equivalent straight life benefit is the greater of:

- The annual amount of the straight life annuity payable under the plan, if any, starting on the same date as the form of benefit actually being paid; or
- The annual amount of a straight life annuity beginning on the same date as the form of benefit actually being paid and which has the same actuarial present value as the benefit being paid, computed using a 5% interest rate and the appropriate mortality table from Treasury Regulation § 1.417(e)-1(d)(2) for that starting date.

2. Cheiron Examples

- Exhibit A and the accompanying examples explain how Cheiron would convert an optional form of benefit for retrospective testing purposes.
- Exhibit B explains how Cheiron would convert an optional form of benefit for prospective testing purposes.

3. QJSA Benefits

No adjustment is required for the actuarial value of a qualified joint and survivor annuity ("QJSA") (a 50%-100% joint and survivor annuity with the spouse as designated beneficiary) that is fully or partially subsidized. See Treas. Reg. § 1.415(b)-1(c)(4).

G. COST-OF-LIVING ADJUSTMENT OF CODE SECTION 415(b) LIMITS

Automatic benefit increases (e.g., cost of living adjustments) to a member's benefits are permitted under Code Section 415(d). However, unless the cost of living adjustment meets the requirements of Treasury Regulation § 1.415(b)-1(c)(5), the value of the future cost of living adjustments must be included in converting the value of the total benefit to a single life annuity. That is, the value of all future cost of living increases must be annuitized over the recipient's life expectancy for 415(b) purposes. This method is more likely to result in violations of the limit than the method provided for COLAs which meet the requirements of Treasury Regulation § 1.415(b)-1(c)(5). That method essentially permits annual testing of the benefit, as increased by the COLA that year, against the 415(b) limit, as increased by 415(d) for that year.

Cost of living adjustments to which no adjustment is required for purposes of 415(b) testing are described as automatic, periodic adjustments applied in the following situations:

- A benefit paid in a form to which 417(e)(3) does not apply (that is, an annuity form of benefit is covered by these new rules);
- A benefit that satisfies 415(b) without regard to the COLA; and
- The plan provides that the benefit payable in any year will not exceed the 415(b) limit applicable at the annuity starting date, as increased annually pursuant to Code Section 415(d).

If the cost of living (or other post-retirement adjustment) is not automatic but rather is ad hoc, then the above is not available and benefits must be retested. Under the Final Regulations, automatic, periodic increases include annual increases according to a "specified percentage or objective index" or automatic increases to "share favorable investment returns on plan assets." Treas. Reg. § 1.415(b)-1(c)(5)(ii).

### 1. Retrospective Testing

For purposes of the 415 VCP filing, SDCERS has agreed that for retrospective testing, all fixed COLAs will be considered as part of the annual benefit for 415 testing purposes, included in the conversion to a single life annuity, and tested against the full 415(b) limit in accordance with Cheiron testing protocols. See Exhibit A (revised). Exhibit A and the accompanying examples illustrate how Cheiron will deal with the COLA retrospectively.

### 2. Prospective Testing

Prospectively, SDCERS may test the annual benefit and COLA against the 415(b) limit for that year as permitted by the Final Regulations. See Exhibit B; see SDMC §24.1004 (amendment pending). However, if the DROP (or any other portion of the benefit) is payable in a form to which 417(e)(3) applies, the simplified method is not available and testing will be conducted as explained under 3 below.

Exhibit B explains how Cheiron will deal with the COLA prospectively.

### 3. Testing with a DROP Benefit Involved

Prospectively, for a participant who takes the DROP benefit in a form to which 417(e)(3) applies, SDCERS will convert the DROP benefit to an annual benefit and reduce the 415(b) limit by that value using the 417(e)(3) factors. The annuity that will be paid will be tested against that reduced 415(b) limit under the Prospective Testing methodology above.

SDCERS believes that it reasonable to interpret the Final Regulations Section 1.415(b)-1(c) to mean that 417(e)(3) applies to the total benefit of any participant who receives the DROP payment in a form to which 417(e)(3) applies and that that analysis should carry over to Treas. Reg. Section 1.415(b)-1(c)(5). Exhibit A addresses this retroactively and Exhibit B explains how Cheiron will deal with this situation prospectively.

## H. CONSIDERATION OF AN ALTERNATE PAYEE'S BENEFITS FOR TESTING PURPOSES

Benefits payable to an alternate payee under a qualified domestic relations order are treated as part of the member's benefit for purposes of applying the benefit limits under Code Section 415. IRS Notice 87-21, Q&A-20; see also Announcement 95-99, Q&A-17.

## I. TESTING OF THE SURVIVOR PORTION OF A BENEFIT

The rules which apply to a member's benefit also apply to a survivor's benefit. Under Code Section 415(b)(1), the annual benefit may not exceed the applicable dollar limit (\$170,000 for 2005). The Code defines "annual benefit" as "a benefit payable annually in the form of a straight life annuity (with no ancillary benefits) under a plan to which employees do not contribute and under which no rollover contributions ... are made." Code Section 415(b)(2)(A) (emphasis added). If a benefit under the plan is payable in any form other than this form,

the determinations as to whether the [415(b)] limitation ... has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by adjusting such benefit so that it is the equivalent to the benefit described in subparagraph (A). For purposes of this subparagraph, any ancillary benefit which is not directly related to retirement income benefits shall not be taken into account; and that portion of any joint and survivor annuity which constitutes a

qualified joint and survivor annuity (as defined in section 417) shall not be taken into account.

Code Section 415(b)(2)(B).

Thus, the benefit that is subject to testing is a straight life annuity, and any other benefit under a plan which is payable in a form other than a straight life annuity (other than a qualified joint and survivor annuity) must be converted to a straight life annuity in order to pass 415(b) testing. In essence, even if a benefit actually being paid is not a straight life annuity, it still should have been converted to a straight life annuity and tested under Code Section 415(b). Thus, upon the death of the retiree, there would be no need for a "conversion" of the survivor's benefit or a change to the existing 415(b) limit as applied to the retiree's benefit. Rather, upon the death of a retiree, the survivor's benefit continues to be tested against the retiree's benefit limit. (This would also be true of a qualified joint and survivor annuity, even though it is not converted to a straight life annuity for testing purposes, because such benefit is exempted from the conversion requirement.)

#### J. AGGREGATION OF TOTAL SDCERS BENEFITS FOR TESTING PURPOSES

Under a multiple employer plan, two (2) or more employers that are not part of a related group participate in the same plan. In applying the Code Section 415 limits to such multiple employer plans, Treas. Reg. § 1.415(a)-1(e) provides that for a participant in a multiple employer plan, benefits or contributions under the plan attributable to such participant from all of the employers maintaining the plan and compensation from all the participating employers must be taken into account. Generally, if the employers had maintained separate plans this rule would not apply, and the Code Section 415 limits would be separately determined for each employer because they are not part of a related group.

### IV. APPLICATION OF CODE SECTION 415(b) TO SDCERS AND RECOMMENDATIONS

The purpose of this Section of this Compliance Strategy Report is to relate the requirements of Code Section 415(b) as outlined in the previous Section to SDCERS.

#### A. PLAN DOCUMENT PROVISIONS

SDMC § 24.1004(h) (*per pending amendment*) provides that employee contributions to, and benefits from, SDCERS must comply with the Code Section 415 limitations on contributions and benefits. The provision further confirms the fiscal year as the testing year retrospectively, and the calendar year as the limitation year beginning on January 1, 2008. SDMC § 24.1004(h) permits SDCERS to modify contributions as necessary to ensure compliance with Code Section 415.

**B. OPERATIONAL COMPLIANCE**

**1. Definition of the Annual Benefit for 415(b) Testing**

Under Code Section 415(b), the benefit that is subject to testing is the benefit payable annually in the form of a straight life annuity ("SLA") with no ancillary benefits to which employees do not contribute and no rollover contributions are made. Code Section 415(b)(2)(A).

**a. *Straight Life Annuity***

The benefit that will be tested is the SLA plus the value of the DROP benefit (if applicable) on a straight life basis.

For purposes of calculating the SLA, the value of any subsidy provided as part of a qualified joint and survivor annuity was included only when the beneficiary was other than a qualified spouse. We understand that using the SDCERS "maximum benefit" would generally accomplish this purpose.

**b. *Post-Retirement Increases***

SDCERS members receive two post-retirement adjustments: a fixed COLA and a 13<sup>th</sup> Check. Certain groups receive additional adjustments: a Supplemental COLA and benefit increases under the Corbett settlement. The protocols in Exhibit A treat the fixed COLA as part of the annual benefit for retrospective testing purposes. The protocols in Exhibit B allow benefits to increase as 415(b) limits increase. With respect to the Supplemental COLA, 13<sup>th</sup> Check and Corbett Settlement, these benefits will also be treated as part of the annual benefit for both prospective and retrospective testing. However, the value of the post-retirement \$2000 death benefit is not included for 415(b) testing. Treas. Reg. § 1.415-3(a)(2)(i)(B).

▪ **Fixed COLA**

As indicated in Exhibit A, retrospectively, the 415(b) limit is adjusted for age and the Fixed COLA in order to identify the initial group which requires further testing. From there, the Fixed COLA will be included with the benefit for purposes of testing those who fail the initial screen. Prospectively, SDCERS will test the benefit and Fixed COLA annually against the 415(b) limit as adjusted by Code Section 415(d), in accordance with the Final Regulations.

▪ **13<sup>th</sup> Check**

In our various meetings, the question has arisen how to treat the 13<sup>th</sup> Check for testing purposes because under the Municipal Code, the 13<sup>th</sup> Check is treated as a contingent benefit. In order to respond to the question, we considered the history of the 13<sup>th</sup> Check. From 1/1/95 to now, in all but two years the 13<sup>th</sup> check was paid in full. In 2003 no 13<sup>th</sup> Check was paid and in another year over 99% of the 13<sup>th</sup> Check was paid. Based upon this history, it was decided that for 415(b) testing purposes, the 13<sup>th</sup> Check will be treated as an additional annual benefit. (Note: This is consistent with the treatment described in the Rollover Compliance Report and VCP Filing.)

- **Supplemental COLA**

For 415(b) testing purposes, the supplemental COLA is already treated as part of the annual benefit. This benefit is referred to in the testing chart as the "Star COLA."

- **Corbett Settlement Amounts**

For purposes of 415(b) testing, the Corbett settlement amount will be treated as part of the annual benefit.

The Corbett-covered group is a closed group.

- **Andrecht Settlement Amounts**

The Andrecht Settlement amounts were included in the calculation of the annual benefit provided by SDCERS. Therefore, no additional adjustment is required for this settlement (in contrast to the Corbett Settlement, which is a post-retirement adjustment).

*c. Factors used in Calculating Actuarial Equivalents*

Where necessary to calculate actuarial equivalents, the applicable mortality assumptions of GAM 83 through December 31, 2002, and thereafter GAR 94, pursuant to Rev. Rul. 2001-62, 2001-2 C.B. 632, were used. An eight percent (8%) interest assumption was used pursuant to SDMC § 24.0902 and Proposed Board Rule 8.41. However, a 5% interest rate was applied to post-retirement adjustments to the maximum dollar limit where benefits begin after the member reaches age 65.

Upon implementation of the Final Regulations, the mortality and interest assumptions for 417(e)(3) and non-417(e)(3) benefits set forth above in III.F.1. will be used.

*d. Exclusion of Recipients of Ancillary Benefits*

It has been determined that individuals who are receiving benefit payments that are not retirement benefits will be excluded from testing. Therefore, SDCERS will not test pre-retirement disability benefits (to the extent not in excess of the qualified disability benefit) or pre-retirement death benefits.

For the pre-retirement disability benefits, SDCERS will still have to apply the 100% of compensation screen. In addition, for the combined pre-retirement disability benefit and the pre-retirement death benefit, SDCERS will apply an incidental benefit test, the 25% of cost test. This will be in addition to, and separate from, the 415 limits.

*e. Ordering Rule*

No benefits will be payable from the SDCERS qualified plan that are in excess of the 415(b) limit. For those members who participate in DROP and who take the DROP benefit in a form that would be an eligible rollover distribution, Cheiron will determine whether the total annual benefit including the DROP benefit would be in excess of the 415(b) limits. SDCERS

has adopted what we have referred to as an ordering rule -- If the DROP benefit could be paid without a violation of the 415(b) limit, then SDCERS will treat the DROP benefit as being entirely paid from the qualified plan. As a result, the DROP benefit can be treated as an eligible rollover distribution. The value of the DROP benefit expressed as an annual benefit will then reduce the 415(b) limit with respect to the annuity payment, which will then be analyzed for compliance with the adjusted 415(b) limit. This ordering approach is the functional equivalent of the following approach: After determining the amount of an excess annual benefit, Cheiron then determines how much of the annuity payment will not be paid from the qualified plan and will be paid from a QEBA. The annual benefit payable from SDCERS is thus reduced to be below the 415(b) limits.

The ordering rule is consistent with the Final Regulation with regard to QEBAs:

Pursuant to section 415(m), in determining whether a governmental plan (as defined in section 414(d)) meets the requirements of this section, the annual benefit does not include benefits provided under a qualified governmental excess benefit arrangement, as defined in section 415(m)(3). Thus, the limitation of section 415(b) does not apply to benefits to the extent the benefits are provided under a qualified governmental excess benefit arrangement.

Treas. Reg. § 1.415(b)-1(b)(4).

There is no requirement under IRS guidance or under the Final Regulations that would require that excess amounts be apportioned between the DROP benefit and the monthly annuity. What is required under the Final Regulations is that the annual benefit payable from SDCERS cannot exceed the 415(b) limit.

## 2. TAMRA Election

SDMC § 24.1010(b) (*prior to pending amendment*) purports to make the TAMRA election for SDCERS benefits. However, the pending amendment to SDMC § 24.1004 would remove the language referencing the TAMRA election, as it is not clear that the requirements of the election were satisfied.

## 3. Age Adjustments Made in 415(b) Testing

### a. *Benefits After Age 65*

For all members whose retirement benefit begins after age 65, the Dollar Limit was appropriately adjusted, as described in Exhibit A with respect to retrospective testing and Exhibit B with respect to prospective testing.

### b. *Benefits Before Age 62 – Other than Qualified Participants*

For all members other than Qualified Participants whose retirement benefit begins before age 62, the Dollar Limit was appropriately adjusted, as described in Exhibit A with respect to retrospective testing and Exhibit B with respect to prospective testing.

*c. Definition of Qualified Participants*

As discussed above, the reduction in the dollar limitation for benefits which begin before age 62 does not apply to Qualified Participants. It is important to keep in mind that the group of public safety employees who may take advantage of this exception is not necessarily consistent with SDCERS' public safety member classification. For example, since EMTs were moved into the fire department several years ago, they could be included as a Qualified Participant (if they meet the service requirements). However, lifeguards were moved into the fire department fewer than 15 years ago; therefore, they do not clearly fall within the exception.

We note that the Final Regulations provide further guidance as to the public safety employees who may take advantage of the exception. Following is a suggested checklist for identifying Qualified Participants:

- Is the member credited in SDCERS with at least 15 years of service as an employee of any police department or fire department of the employer? If no, then apply pre-age 62 screen. If yes, proceed to next question. Note: The 15 years must be with an SDCERS employer, not via reciprocity.<sup>1</sup>
- Was the member a full-time employee of any police department or the fire department for all of those 15 years of service? If no, then apply pre-age 62 screen. If yes, do not apply pre-age 62 reduction. Count a person as a full-time employee of the department even if they are not a public safety officer. For example, if a person was a secretary in the fire department, they are a Qualified Participant. Service with the departments should be counted, including all periods of service, e.g., count such service that occurred before termination and reemployment. For example, if a member worked on probation for his first six months and then purchased that time, it should be included. A second example is a person who worked for one of the departments for three years, then left and took a refund. He then returned to the department and purchased those three years. They should be included.

SDCERS staff has asked whether this exception for public safety officers requires that all fifteen (15) years of service be with the same department, or whether the service might be spread among two or more departments. In addition, SDCERS staff has asked whether police and military service can be combined to meet the 15-year requirement. The language of the Code is ambiguous on this point. However, an example in the Final Regulations makes it clear that a combination of police department and military service can be used to satisfy the 15 year requirement. Given this, we think it is reasonable to take the position that any combination of police department and/or fire department service (that otherwise qualifies) may also be used to meet the 15 year requirement. We therefore are comfortable with the testing being done using the combination of all San Diego police and fire department service and military service.

<sup>1</sup> If the City plan, the Airport plan, and the Port plan are considered as separate plans, the Final Regulations may not permit combining service.

Park Rangers, who are not in the police department, but who exercise police powers in the City parks will not be treated as qualified participants, as agreed during the VCP process.

*d. Exclusion of Pre-Age 62 Reduction for Disability or Death Benefits*

The pre-age 62 reduction would not be applied to a SDCERS disability benefit or to a death benefit. Code Section 415(b)(2)(I).

4. 10-Year Adjustment

SDCERS must identify those retirees who have fewer than ten (10) years of service with SDCERS, exclusive of reciprocity and exclusive of service purchases. Those retirees would have a reduced 415(b) test amount – for example, if the retiree only had five (5) years of service with SDCERS (exclusive of reciprocity and service purchases), the retiree's age-adjusted limit would be 50% of the age-adjusted limit. The limit can never be lower than 10% of the otherwise applicable limit. We realize this could create failures because of several design elements (i.e., the Port and Airport Plans have a five year vesting schedule, reciprocity provisions that allow for crediting service in other plans, a pre-1992 group who had less than 10 years of service but were vested as a mandatory retirement age group, and the SPSP "5+5" group). These adjustments are described in Exhibit A with respect to retrospective testing and Exhibit B with respect to prospective testing.

C. AMOUNTS EXCLUDED FROM TESTING

Following is a discussion of the elements that have been considered for exclusion in the screening and testing process.

1. After-Tax Employee Contributions

For 415(b) testing purposes, the portion of the annual benefit that is attributable to after-tax employee contributions may be "subtracted" from the annual benefit. In order to perform this calculation, SDCERS would have to be able to identify mandatory employee contributions that were made prior to the adoption of the pick-up and any voluntary post-tax contributions (including after-tax contributions for service purchases). However, based upon the changes made by the PPA with regard to service purchases and the difficulty in performing 415(c) testing, we ultimately recommend that in the testing protocol the benefit attributable to after-tax employee contributions not be excluded from 415(b) testing, which would be consistent with Code Section 415(n) testing.

*a. Mandatory Employee Contributions*

SDCERS implemented a pick-up of mandatory contributions in 1987<sup>2</sup> for all contributions made by the employer. Prior to that time mandatory employee contributions were made on an after-tax basis; therefore, under the IRS regulations the benefit attributable to those mandatory contributions would be excludible from 415(b) testing. However, if those mandatory contributions exceed the 415(c) limits, the benefit attributable to the excess contribution would

<sup>2</sup> This date was provided by staff on 12/7/2005.

not be excludible. These pre-87 contributions will only be "backed out" from the 415(b) testing in cases where a failure has been identified in the testing group under the prospective methodology. The initial screen will leave them in.

*b. Voluntary USERRA Contributions*

It is our understanding that USERRA contributions are subtracted from any differential pay for the member. However, if the member did not receive differential pay, the member would be given the opportunity to pay those contributions on an after-tax basis. Therefore, SDCERS would be permitted to exclude the benefit attributable to the post-tax USERRA contributions from 415(b) testing, if the post-tax USERRA contributions would not have exceeded the 415(c) limits in the year of service.

*c. DROP Contributions*

SDMC § 24.1404(c)(4) provides that DROP contributions are made pursuant to a 414(h) pick-up. Therefore, the benefit attributable to these contributions would be included in 415(b) testing.

*d. Voluntary Contributions for Permissive Service Credit Purchases; Missed Contributions*

As noted above, the amount contributed for permissive service credit may either be tested under a modified 415(c) or 415(b) test. SDCERS will use the modified 415(b) test.

When SDCERS has determined that contributions have not been remitted for a period of service, the member is "billed" for these contributions as a pre-condition for receiving credit for that period of service. If those missed contributions are paid by the member with after-tax dollars, those contributions would be tested under Code Section 415(n) using the modified 415(b) test.

As a result of the PPA, all SDCERS service purchases would be considered to be permissive service credit purchases. As a result, those service purchases will be tested under the modified 415(b) testing of Code Section 415(n).

*e. Proposed Correction Approach*

The proposed correction approach for retrospective testing does follow 415(b) testing with respect to after-tax contributions made for permissive service purchases under Code Section 415(n). See Exhibit A. The expanded testing of the pre-1995 Group will consider mandatory after-tax employee contributions (pre-pick-up).

Starting with January 1, 2007, and on a prospective basis, 415(n) testing will be applied for all permissive service purchases.

We also recommend, as a going-forward matter, that SDCERS keep a record of the type of service purchased and the source of the purchase. This will be done by reprogramming PensionGold (the SDCERS operating system).

PensionGold currently has fields with drop down selections that are used to identify the sources of money received for the payment of Purchase Service Contracts:

Payment Type Choices:

401k Transfer  
 Balance Adjustment  
 Cashless Transfer<sup>3</sup>  
 Lump Sum Payment  
 Manual  
 Rollover  
 SPSP Transfer  
 Transmittal

If the Rollover option is selected as the Payment Type, the "Rollover information" section is enabled. This section has a "Type" field with the following selection options:

401(k)  
 403(b)  
 457  
 Individual Retirement Account  
 Other Qualified Plan

Other fields in the Rollover information section include:

Acct. Name  
 Acct. Number  
 Acct. Holder

Each Payment received is identified in the system as "Pre or Post tax," as well as tied directly to a specific contract which identifies the service purchase type.

To provide for accurate prospective 415(n) testing, we recommend that an additional payment type be identified as 457(b) or 403(b) direct transfer to identify those situation where *permissive service credit is being purchased*. We also recommend that the specific type of service being purchased be identified so that it can be determined that an appropriate source of funding was used.

**2. Rollovers**

The amount of the annual benefit that is attributable to rollovers may be excluded from 415(b) testing. As noted above, the benefit attributable to a rollover must be calculated in a manner permitted by the IRS. The properly calculated benefit attributable to the rollover could be "subtracted" from the annual benefit for testing purposes. Appropriate conversion factors for rollover purchases will be utilized as specified in Exhibits A and B.

<sup>3</sup> This type of transfer is addressed in a separate VCP filing and Report.

### 3. Transfers from a Qualified Plan

With regard to transfers from a qualified defined contribution plan, the amount attributable to the transfer would be excludible from 415(b) testing using IRS prescribed factors. However, if there is a transfer from another defined benefit plan where aggregation is required (because, for example, the plans are maintained by the same employer or related employers), then the total benefit would be tested under 415(b). If the transfer is not from a defined benefit plan where aggregation is required, then the benefit attributable to the transferred amount is treated as if provided as an annuity from a separate plan which must be aggregated with the transferor plan.

### 4. Transfers from a 403(b) or 457(b) Plan

Amounts received in a transfer from a 457(b) or 403(b) plan are treated in the same manner as a rollover, as discussed above.

### 5. Purchase of Service Chart

The following chart identifies the various purchases that may be made under the Municipal Code<sup>4</sup> and our assessment of whether they would appropriately be categorized as permissive service credit – qualified or non-qualified – and the types of contributions that could be used for the purchase. For the category "permissive service," we are assuming that SDCERS assures that there is no double-counting of service and only one year of credit may be received for any 12 month period. For the category "sources" we are referring to whether all types of employee contributions can be made for the purchase – after-tax contributions under 415(n), rollovers, plan-to-plan transfers from a DC qualified plan, and plan-to-plan transfers from a 457(b) or 403(b) plan.

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
Missed Contributions	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1301 – LTD	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).

<sup>4</sup> Board Rules 10.00-10.40 describe Board policy with respect to the purchases that are set forth in the Municipal Code.

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
24.1302 – Probation. Employee contributions only	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1303 – City Service	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1303 – 1981 Plan – waiting period	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1304 – Part-time, hourly pre 1/2/97	Yes (no double counting)	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1305 – Reinstatement – pre 1/2/97	Yes (no double counting)  415(k) Service	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1306 – Repayment of refunds – contributions plus interest	Yes 415(k) Service	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
24.1307(a) – Approved leave (one year) by payment of "employee cost" for leaves that begin before 2/1/97	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1307(b) – Approved leave (more than one year) by payment of employee and employer cost for leaves that begin before 2/1/97.	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1307(c) – After 1/1/97, LTD, FMLA, leaves without pay.	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1308 – Field of Membership	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1309 – Military Service: USERRA service (Per SDCERS, this only covers USERRA service.)	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n). <b>Note:</b> Electing this for convenience could be treated separately from all other service.

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
24.1312 – 5 year purchase – No period of service identified	Yes	Nonqualified	All	Back out benefit attributable to rollovers, DC and 45 (b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).

#### 6. 401(h) Amounts

Payments made from the 401(h) account do not count toward the Code Section 415(b) limit. Treas. Reg. § 1.415-3(d)(2)(ii). However, Code Section 415(l) provides that contributions allocated in an "individual medical account" shall be treated as an annual addition to a defined contribution plan, but are only subject to the 415(c) dollar limit (not the compensation limit).

However, it is our understanding there are currently no SDCERS reserves left to pay this 401(h) benefit. Furthermore, the pending amendments to SDMC § 24.1203 will eliminate the 401(h) account entirely. Consequently, retiree medical is either paid from other sources or not paid at all.

#### 7. Aggregation of Payments to Alternate Payees

For purposes of 415(b) testing, SDCERS must aggregate payments to the member with any payments to alternate payees under the community property laws, including payments made pursuant to child support and spousal support orders. PensionGold was modified as of January 1, 2003, so that all payments made with respect to a member are "associated" with the member. In addition to payments to alternate payees, the "association" also includes deductions from the member's benefit such as an IRS levy. In order to have accurate 415(b) testing both prospectively and retrospectively, all "disassociated" payments must be associated with the appropriate SDCERS member. That "association" was done only with respect to the "initial failure" group. (Please note that the initial group screen did include a 20% load for other than member payments.) Therefore, the total population has not been "associated." The initial failures were "associated." Prospectively, SDCERS must "associate" all members when tested.

#### D. CLASSIFICATION OF EMPLOYER CONTRIBUTIONS

SDCERS staff has indicated that the SDCERS system does not track employer contributions as to what portion represents an offset contribution and what portion represents a pick-up (as Code Section 414(h)(2) defines the term) contribution. The result is that the benefit attributable to any employer contribution (regular, offset, and pick-up) will be subject to 415(b) testing. This is the appropriate result under Code Section 415(b).

In order to enhance future compliance efforts, we strongly recommend that SDCERS and the plan sponsors use the term pick-up in the manner provided for in Code Section 414(h)(2).

E. **CONCLUSIONS REGARDING RETROSPECTIVE 415(b) TESTING**

1. **Definition of Tested Group – Post-1994 Group**

In its original VCP, SDCERS, working with Ice Miller and Cheiron, developed a protocol for determining whether there have been 415(b) violations in prior years with respect to the group that retired on and after 1/1/95. This protocol began by identifying the entire population of 6652 retirees. That total was initially reduced by disabilitants who were not receiving a service retirement. After removal of records reflecting deceased or suspended participants, this remaining group consisted was then tested under 415(b). See Exhibit A for the assumptions that were used in testing this group. This date (1/1/95) was selected for the following reasons:

**From a Benefit Standpoint**

1. The DROP benefit is one of the potential "causes" of 415(b) failures. The DROP benefit was initiated after January 1, 1995 (April 1997). Therefore, all DROP recipients are being tested under the new protocol.
2. Using the 1/1/95 date captures all of the Corbett and Andrecht settlement amounts.
3. Service purchases are another potential cause of 415(b) failures. The largest service purchase programs were initiated after January 1, 1995.
4. Multiplier increases are another potential cause of 415(b) failures. The most recent multiplier increases took effect in 1997 and 2002.

**From the Code Standpoint**

1. The grandfather provision enacted with Code Section 415(m) applies to benefits prior to January 1, 1995.
2. The grandfather provision enacted with Code Section 415(n) applies to any service purchase in effect on August 5, 1997.

2. **Additional Testing Group – Pre-1995 Group**

As a result of discussions during the VCP process, Cheiron has now developed a testing protocol for those SDCERS members who retired pre-1995. This is now reflected in Exhibit A.

3. **Additional Testing Group – Deceased Retirees**

At the November 19, 2007, meeting with the IRS it was determined that Cheiron needed to develop a way to estimate the number of deceased retirees for whom there were no continuance benefits being paid, because they had not been tested previously.

To estimate the potential payments made to retirees who have died, Cheiron looked at the last five years experience. Over the past five years, the average number of retirees who died per

year was 137. The average number of participants in receipt of benefits in excess of the 415(b) dollar limit was 1.02% of the retirees. Therefore if 1.02% of the deaths were receiving benefits in excess of the 415(b) dollar limit they would add 1.4 more retirees to our testing. During this same five year period, the average amount of benefit in excess of the limit was \$26,000, so the amount in each year potentially attributable to deaths is \$36,400 (1.4x\$26,000).

4. Benefits Payable from the Qualified Plan

As a result of the Retrospective Testing, the City will be required to repay to the qualified plan the amount of benefits that were paid from the qualified plan in excess of the 415(b) limits.

F. CONCLUSIONS REGARDING PROSPECTIVE TESTING

1. Definition of Tested Group

All members who retire on and after July 1, 2008, will be tested in accordance with the 415(b) protocols being developed by Cheiron, a draft of which is set forth in Exhibit B. To the extent information is available on pre-pick-up employee contributions, the after-tax contributions will be backed out for 415(b) testing.

2. "Screens" Used in Testing

Linea will build screens based upon PensionGold (the software used by SDCERS) fields.

3. Benefits Payable from the Qualified Plan

No benefits in excess of the 415(b) limit will be payable from SDCERS.

V.

OVERVIEW OF LAW WITH RESPECT TO  
DEFINED CONTRIBUTION LIMITS

Annual additions made or deemed to be made to a defined contribution plan are subject to the limits under Code Section 415(c). This test is applied on an annual basis and it is applicable to those governmental defined benefit plans that provide for after-tax employee contributions or certain purchases of service. Thus, after-tax employee contributions and after-tax payments for purchases of service are tested under the Code Section 415(c) limits, in the same manner as contributions to a separate defined contribution plan. Treas. Reg. § 1.415(c)-1(a)(2)(ii).

A. THE DOLLAR LIMIT ON "ANNUAL ADDITIONS"

1. Current Limits

The defined contribution limits contain both a Dollar Limit and a percentage of compensation limit ("Percentage Limit"). EGTRRA increased the Dollar Limit for defined

contribution plans from \$35,000 to \$40,000 for plan years beginning in 2002. This \$40,000 dollar limit is subject to more rapid indexing, with annual cost of living adjustments in \$1,000 increments instead of the current \$5,000 increments.

Under prior law, the Percentage Limit did not permit contributions to exceed 25% of compensation. However, EGTRRA amended this limit for plan years beginning in 2002, and permitted annual additions to defined contribution plans of up to 100% of the participant's compensation, or \$40,000 (as adjusted for inflation), whichever is less. For purposes of this definition, "compensation" includes both elective deferrals to a 401(k) plan or 403(b) plan and amounts contributed or deferred by the employer at the employee's election under a cafeteria plan, qualified transportation fringe benefit plan, or a 457 deferred compensation plan.

Certain contributions are not included in the definition of "annual additions" that are tested under Code Section 415(c). Mandatory employee contributions that are picked-up by an employer, or service purchase payments paid for by pre-tax (picked up) installment payments, simplify Code Section 415 testing because mandatory contributions or service purchase installment payments picked up pursuant to Code Section 414(h)(2) are not required to be treated as contributions to a separate defined contribution plan. However, the resulting benefit must be tested under Code Section 415(b) upon separation.

Treasury Regulation § 1.415(c)-1(b)(3) provides that rollover contributions are not treated as employee contributions and thus are not "annual additions." Additional exceptions from the 415(c) limits include USERRA contributions and restoration of forfeited benefits, which are discussed below.

## 2. The Limitation Year

The limitation year for 415(c) testing purposes will be determined (see pages 2-3) in the same fashion as for 415(b) testing purposes.

The Final Regulations for Code Section 415(c) state the following with respect to the impact of a change in the 415(c) limits in the case of a plan that has a Limitation Year that is not the calendar year:

The adjusted dollar limitation applicable to defined contribution plans is effective as of January 1 of each calendar year and applies with respect to limitation years ending with or within that calendar year. Annual additions for a limitation year cannot exceed the currently applicable dollar limitation (as in effect before the January 1 adjustment) prior to January 1. However, after a January 1 adjustment is made, annual additions for the entire limitation year are permitted to reflect the dollar limitation as adjusted on January 1.

Treas. Reg. § 1.415(d)-1(b)(2)(iii). Applying this regulation to the SDCERS situation, we would come up with the following scenarios:

- If a member wished to contribute after-tax dollars during the time period July 1, 2006 through December 31, 2006, the member would be limited to a contribution

of \$44,000 (assuming that his compensation in that Limitation/Fiscal Year was equal to or greater than \$44,000).

- If a member contributed an amount from \$1 through \$44,000 prior to January 1, 2007, the proposed regulation would permit the member to contribute the difference between the amount contributed prior to January 1 and \$45,000 on and after January 1, 2007, through June 30, 2007. For example, if a member contributed \$44,000 prior to January 1, 2007, on and after January 1, 2007, and through June 30, 2007, the member could contribute \$1,000, under the regulation.

### 3. Code Section 415(k)(3): Repayment of Cash-Outs

Section 415(k)(3) provides that any repayment of contributions (including interest) will not be taken into account for Code Section 415 purposes if the repayment is to a governmental plan with respect to an amount previously refunded on a forfeiture of service credit under that plan or any other governmental plan maintained by the state or any local governmental employer within the same state.

### 4. Testing of USERRA Service Purchases

Special Code Section 415 testing rules apply to the payment of contributions covered by the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"). Pursuant to Code Section 414(u)(1)(A) and (B), payments made in the applicable USERRA "make-up" period shall not be included in the Code Section 415(c) test for the limitation year in which the payment is made, and shall instead be allocated to the limitation year for which it relates. This rule exists to address a situation in which make up contributions permitted by USERRA for multiple years, in addition to the regular on-going contributions, were all made at once upon the return of a plan member on USERRA-approved leave. If the Code Section 415(c) limits were applied to the sum of these contributions, then a member might exceed the applicable limit.

In SDCERS' case, generally in "real life," the employee is being paid differential pay while on military leave, so their regular deductions for contributions remain as is (on a pre-tax basis). For the few employees who do not receive sufficient pay throughout the period to remain current on contributions, they are given options on how to restore contributions (e.g., lump sum installments). This group may need to be moved to an Exception Management process.

### 5. Code Section 414(v)

Code Section 414(v) provides that an "applicable employer plan" may permit an eligible participant to make additional elective deferrals in any plan year subject to certain limits. An "applicable employer plan" includes a 401(a) plan, a 403(b) plan, a SEP or a SIMPLE IRA, and a 457(b) plan. An eligible participant means a participant in the plan who will attain age 50 in the plan year and who would otherwise be "capped" out by other Code limitations. These additional elective deferrals may not exceed the lesser of the "applicable dollar amount" (for 2006 and thereafter this amount is \$5,000) or the difference between the participant's compensation minus all other elective deferrals. For purposes of applying this limit, all 401(a) plans, 403(b) plans, SEPS and Simple IRAs of a single employer must be aggregated. Multiple 457(b) plans of a

single employer must be aggregated, but are not aggregated with the other types of employer plans.

An additional elective deferral under Code Section 414(v) will not be subject to the otherwise applicable limitation under Code Section 401(a)(30), 402(h), 403(b), 408, 415(c), and 457(b) (determined without regard to 457(b)(3)).

Therefore, in determining whether an SDCERS member who makes an after-tax employee contribution is violating the 415(c) limits, the member's 415(c) limit is determined without regard to any additional elective deferral made under Code Section 414(v).

## B. DEFINITION OF COMPENSATION

### 1. General Rule

Code Section 415(c)(3)(A) defines "participant's compensation" as "the compensation of the participant from the employer for the year." Code Section 415(c)(3)(D) includes as compensation elective deferrals under Code Section 402(g)(3) and amounts contributed by the employer at the election of the employee which are excluded from income under Code Sections 125, 132(f)(4), or 457.

Treas. Reg. § 1.415(c)-2(b) provides the following definition of compensation:

For purposes of applying the limitations of section 415, except as otherwise provided in this section, the term "compensation" means remuneration for services of the following types:

(1) The employee's wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (or to the extent amounts would have been received and includible in gross income but for an election under section 125(a), 132(f)(4), 402(e)(3), 402(h)(1)(B), 402(k), or 457(b)). . . .

\* \* \*

(3) Amounts described in sections 104(a)(3), 105(a), and 105(h), but only to the extent that these amounts are includible in the gross income of the employee.

(4) Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under section 217.

\* \* \*

- (7) Amounts that are includible in the gross income of an employee under the rules of section 409A or section 457(f)(1)(A) or because the amounts are constructively received by the employee.

Code Section 104(a)(1) excludes from gross income amounts received under workmen's compensation acts as compensation for personal injuries or sickness.

## 2. Safe Harbor Definitions

There are at least three safe harbor options available to a plan for purposes of defining compensation for Code Section 415(c):

- (1) Define compensation on a person by person basis, including all taxable income and certain items not included on Form W-2, imputed income items, etc. This approach has the advantage of producing the highest possible compensation amount for each individual, but is not administrable for a plan of any size. In order to take this approach, it would be necessary for SDCERS to determine the tax treatment of domestic partner health coverage and various other items.
- (2) Define compensation based on the number reported by the employer as gross income in Box 1 of each employee's Form W-2. This approach results in a lower number than method 1, but is much easier to administer.
- (3) Define compensation based on amounts subject to federal income tax withholding, as well as certain amounts that would be includible except for an election under a cafeteria plan, a qualified transportation fringe benefit, a 401(k) plan, a 403(b) plan, a simplified employee pension, a simple retirement account, or a 457(b) plan. This approach also results in a lower number than method 1, but is generally easily available from the employer or payroll service provider and is therefore much easier to administer than an individualized approach.

The definition of Compensation that SDCERS has selected is the method found in the Final Regulations Section 1.415(c)-2. SDCERS had considered using the Medicare compensation amount. However, that compensation definition includes picked-up contributions in certain situations. Therefore, SDCERS protocols for 415(c) testing would be based upon the Final Regulation as indicated.

## 3. Treatment of Workers Compensation

Plans often question how to treat workers compensation payments for purposes of the Code Section 415(c) definition of compensation. Generally, workers compensation payments are excluded from gross income, provided they are paid under a workers compensation statute, and therefore would not be includible as compensation under Code Section 415(c)(3). We believe this is true regardless of whether the employer is funding the payments directly or has paid for worker's compensation insurance, as in either case the amounts paid would (presumably) be paid pursuant to a worker's compensation statute.

There is a special rule under Code Section 415(c)(3)(C) which provides as follows:

(C) SPECIAL RULES FOR PERMANENT AND TOTAL DISABILITY. In the case of a participant in any defined contribution plan—

- (i) who is permanently and totally disabled (as defined in section 22(e)(3)),
- (ii) who is not a highly compensated employee (within the meaning of section 414(q)), and
- (iii) with respect to whom the employer elects, at such time and in such manner as the Secretary may prescribe, to have this subparagraph apply,

the term "participant's compensation" means the compensation the participant would have received for the year if the participant was paid at the rate of compensation paid immediately before becoming permanently and totally disabled. This subparagraph shall apply only if contributions made with respect to amounts treated as compensation under this subparagraph are nonforfeitable when made. If a defined contribution plan provides for the continuation of contributions on behalf of all participants described in clause (i) for a fixed or determinable period, this subparagraph shall be applied without regard to clauses (ii) and (iii).

Treasury Regulation § 1.415(b)-1(b)(2)(iv) and Treasury Regulation § 1.415(c)-1(a)(2)(ii)(B) provide that the voluntary and mandatory employee contributions (but not picked up contributions) under a defined benefit plan are treated as a separate defined contribution plan maintained by the employer, subject to the limitations on contributions of Code Section 415(c) and Treasury Regulation § 1.415(c)-1. Thus, while Code Section 415(c)(3)(C) specifies its applicability to defined contribution plans, it could be argued that these provisions would be applicable to that portion of a defined benefit plan that is to be treated as a defined contribution plan.

Treasury Regulation § 1.415(c)-2(g)(4) provides that, if certain conditions are satisfied, then "compensation" for a defined contribution plan participant who is permanently and totally disabled means "the compensation the participant would have received for the year if the participant was paid at the rate of compensation paid immediately before becoming permanently and totally disabled, if such compensation is greater than the participant's compensation determined without regard to this paragraph." For this rule to apply, the following conditions must be satisfied:

- (1) Either the participant is not a highly compensated employee (as defined in section 414(q)) immediately before becoming disabled, or the plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled for a fixed or determinable period;
- (2) The plan provides that the rule of this paragraph (g)(4) (treating certain amounts as compensation for a disabled participant) applies with respect to the participant; and

(3) Contributions made with respect to amounts treated as compensation under this paragraph (g)(4) are nonforfeitable when made.

Treas. Reg. § 1.415(c)-2(g)(4)(ii).

This special rule provides that in the case of an individual with a total and permanent disability, Code Section 415(c) compensation would be deemed to be compensation at the rate the employee was being paid prior to the disability. This then leads to the question of how this provision is applied. Based on the Final Regulations, it appears that Code Section 415(c)(3)(C) is definitional for 415(c) compensation purposes, thereby creating a base for applying the 415(c) limit.

In SDCERS' case, the City has industrial leave paid under the active payroll, with the possibility the person will go to a different payroll (*i.e.*, workers compensation). This may require that a person in this situation be moved to an exception management process.

#### C. SERVICE PURCHASES

In our earlier report, we noted that one of our primary areas of concern with regard to 415(c) testing was with respect to service purchases. A voluntary employee after-tax contribution is subject to 415(c) testing unless the more advantageous provisions of Code Section 415(n) apply. However, the PPA has made 415(n) much broader so that the more favorable limits would apply to all SDCERS service purchases, subject to 415(n) limits.

As noted in an earlier section of the report, if an employee makes a voluntary contribution for a service purchase, the voluntary contribution may be tested under more generous 415(c) limits or 415(b) limits. The 415(c) limits under 415(n) are as follows:

For purposes of Code Section 415(n) service purchases, only the dollar limit under Code Section 415(c) applies (\$40,000 (adjusted for inflation)) by treating all permissive service contributions as an annual addition under that limit.

#### D. ANALYSIS OF ALL CITY PLANS

Code Section 415(g) requires the aggregation of all plans of an employer for 415 testing purposes. Therefore, our other primary area of concern for 415 testing occurs with respect to the other defined contribution plans that are maintained by the City - the 401(k) plan and the SPSP. The City's 457(b) deferred compensation plan is not aggregated with SDCERS.

### VI.

#### APPLICATION OF CODE SECTION 415(c) TO SDCERS AND RECOMMENDATIONS

##### A. PLAN DOCUMENT PROVISIONS

SDMC § 24.1004(h) (*per pending amendment*) provides that employee contributions to, and benefits from, SDCERS must comply with the Code Section 415 limitations on contributions and benefits. The provision further establishes the fiscal year as the testing year, retrospectively.

and the calendar year, prospectively. The amendment would permit SDCERS to modify contributions as necessary to ensure compliance with Code Section 415.

**B. TESTING OF "ANNUAL ADDITIONS"**

**1. Plan Aggregation**

Prior to 1/1/06, SDCERS has not tested annual additions against the Code Section 415(c) limitations. The City administers three defined contribution-type plans: the 401(k), SPSP, and a 457(b) plan. The City tests elective deferrals to the 401(k) and 457(b) plans. The City does not conduct Code Section 415(c) testing for its 401(a) plans (401(k), SPSP, and SDCERS). The other City plans and SDCERS are subject to qualification failure if the 415(c) testing requirement is not satisfied and individuals are contributing in excess of the limitations to the plans in the aggregate. In order to address this qualification issue, SDCERS would have to coordinate with City to test for both the dollar and compensation limits under Code Section 415(c). In order to perform this test, SDCERS must select a definition of compensation that is permitted under the Code (see next section). The pre-tax (picked-up) contributions to SDCERS would not be used in the 415(c) testing.

If the after-tax contribution was made for a purchase of permissive service credit, Code Section 415(n) would apply and permit a higher level of contribution than under Code Section 415(c) or testing under 415(b).

The Airport and Port only offer a 457(b) plan; they do not provide a 401(k) or 401(a) plan. As a result, 415(c) testing for SDCERS purposes would not require aggregation with the Airport and the Port 457(b) plans.

**2. Definition of Compensation**

We discussed the three safe harbor definitions of compensation with SDCERS staff. Currently, none of the compensation fields provided by the City in Pension Gold represents any of the safe harbor definitions. SDCERS staff and the City have compared W-2 compensation used by the City with "gross compensation" reported as Gross Salary in Pension Gold. SDCERS staff has determined that the compensation numbers that are currently provided to SDCERS by the plan sponsors do not comport with any of the three safe harbor definitions. The IRS has indicated that the Medicare definition of compensation is not acceptable because it would include pick-up contributions in some cases. Therefore, SDCERS will use the definition found in the Final Regulations Section 1.415(c)-2. Testing protocols will be conformed to this change.

Finally, please note that all plans which must be aggregated for purposes of 415(c) testing must use the same definition of compensation for those purposes. Therefore, if the plan sponsors are using a different definition of compensation for purposes of their testing, SDCERS must collaborate with them to arrive at a consistent approach.

### C. CONCLUSIONS REGARDING RETROSPECTIVE 415(c) TESTING

Given the 415(b) testing approach described in earlier sections of this Report, SDCERS is proposing not to do retrospective 415(c) testing for service purchases that fit within 415(n). This should be a reasonable approach considering the following factors:

- Since 1987, all mandatory employee contributions have been picked-up and thus would be subject to 415(b) testing.
- Since 1997, all service purchases made with after-tax employer dollars are subject to either modified 415(c) testing or modified 415(b) testing. SDCERS has elected 415(b) testing. The PPACA has confirmed the availability of this methodology.
- Service purchases permitted as of August 5, 1997 are grandfathered and thus are not subject to 415(c) testing.
- For retrospective 415(b) testing, SDCERS is not backing out any after-tax employee contributions, except where information is available for mandatory post-tax contributions.
- Service purchases made via rollover and plan-to-plan transfer from the DC plans are not subject to 415(c) testing.
- Service purchases made by plan-to-plan transfers from the 457(b) plan are subject to regular 415(b) testing.

### D. CONCLUSIONS REGARDING PROSPECTIVE 415(c) TESTING

Given the practical problems associated with 415(c) testing, SDCERS has determined to take the following prospective approach starting January 1, 2007.

#### 1. Definition of Tested Group

The tested group will consist of all employees making after-tax contributions (other than service purchases) on and after January 1, 2007.

#### 2. Testing of Service Purchases Made with After-Tax Employee Contributions

All service purchases made with after-tax employee contributions will be tested under the modified 415(b) testing under 415(n) if the service being purchased is permissive service, including qualified and nonqualified service, in accordance with the chart above. This means the benefit attributable to these contributions will not be tested under 415(c).

#### 3. Testing of Other After-Tax Employee Contributions

SDCERS does not anticipate that any after-tax contributions would be received that did not qualify as contributions for the purchase of permissive service credit. Therefore, all would

be tested under 2 above. However, SDCERS is retaining an "exception test" procedure for 415(c) in case SDCERS wishes to use the modified 415(c) testing in the future for service purchases or if other conditions arise which would require it (such as a change in the law).

4. USERRA Testing

In the case of USERRA contributions, the 415(c) limits that would be examined would be the limits in place with respect to the covered service – not necessarily the year of the payment.

5. Compensation Definition

The compensation definition that will be used in 415(c) testing (if it is necessary) has been stated in the proposed amendment to SDMC § 24.1004.

6. Testing Protocol

The testing protocol for this is set forth in Exhibit D. This testing protocol will be changed with respect to the definition of compensation.

7. Priority

One issue raised in this context is that of "priority." That is, it is important that a clear priority be established among the different plans as to what will be reduced first, second, etc. in the event that annual additions exceed the Code Section 415(c) limitation. This priority list should include not just the different San Diego defined contribution plans, but also the different types of contributions possible to each of those plans.

- First, attempt the correction through the 401(k) program. The amount of excess contributions would be distributed to the member.
- If the amount of 401(k) contributions for the year is not enough for the correction, then the next plan to consider would be SPSP. However, in order to preserve the plan's status as the Social Security replacement plan, the amount of contributions available to be refunded would be limited to the voluntary contributions.
- If the amount in the SPSP available for refund was insufficient to make the correction, then the correction would have to be made from SDCERS. This could affect the member's service purchase.

E. TESTING OF SERVICE PURCHASES – BY SOURCE

1. SDCERS Provisions

SDMC § 24.1310(a) provides that in order to purchase Creditable Service a member must pay an amount, including interest, determined by the Board before the effective date of retirement. This section goes on to provide as follows:

- (b) Subject to any limitations imposed by the Internal Revenue Code, such payments under section 24.1310(a) may be made by lump sum, installment payments, direct transfer to the Retirement System from any defined contribution plan maintained by the City of San Diego, or in such manner and at such time as the Board may by rule prescribe. Any sums paid by a Member under section 24.1310 are considered to be and administered as Member contributions.

SDMC § 24.1310(b). The Board has adopted rules under this section, which the Board has recently amended to read as follows:

**Rule 10.50    Methods of Payment.**

- (a) Subject to any limitations or conditions imposed by applicable tax laws and regulations, a member may pay for service credit by:

- (1) lump sum,
- (2) installment payments through payroll deduction,
- (3) direct transfer to the Retirement System from any tax qualified defined contribution plan maintained by the City, Airport Authority or Unified Port District,
- (4) rollover or direct transfer of funds from an eligible retirement plan,
- (5) direct in-service transfer from an IRC 457(b) compensation plan or an IRC 403(b) plan, subject to Board Rule 10.60 (subject to prior approval by the IRS); or
- (6) any other source allowable under federal law.

- (b) The System will treat all amounts paid by members under this Division as member contributions.

- (c) A member must complete all payments to purchase service credit before his or her effective date of retirement, entry into DROP, or termination of employment (in the case of a deferred retirement).

- (d) If a member elects to make installment payments:

- (1) the member must agree to an installment contract with a payment plan that includes the purchase cost plus installment interest,
- (2) the payments must be made through payroll deduction,
- (3) the payments must be at least \$20 per pay period,

- (4) the System will charge installment interest to the member's individual account using the actuarial assumed interest rate in effect at the time the installment contract is executed, and
- (5) if making pre-tax payments, the member must complete the installment contract before he or she first becomes eligible to service retire, unless the member acknowledges in writing the negative consequences of failing to do so. (See form SDCERS uses for this. See Exhibit L.)

Board Rule 10.50.

The Board has adopted Rule 10.60 to read as follows:

**Rule 10.60 In-Service Transfer of Funds from a 457 Defined Compensation Plan to Purchase Service Credit.**

- (a) Purchase of Service Credit under General Five-Year Provision (Board Rule 10.10): A member may purchase service under Board Rule 10.10 (general five-year purchase) by an in-service plan-to-plan transfer from a 457(b) plan. No certification of corresponding service is required.
- (b) Purchase of "Service-Connected" Service Credit. A member may purchase service-connected service credit under Board Rule 10.00 by an in-service plan-to-plan transfer from a 457(b) plan. No certification of corresponding service is required.

With this new Rule 10.60 in place, transfers from the 457 plan will be accepted for service purchases as described in (a) and (b). See PLR 200550042.

The Board Rules also provides for the terms of installment contracts in Board Rule 10.70. Based upon these rules, it is clear that SDCERS has attempted to avail itself of all methods of service purchases.

**2. Compliance Testing Chart**

The following chart shows how the available sources of voluntary employee contributions for service purchases should be tested under either Code Section 415(c) or 415(n). (Refer to the earlier chart for a categorization of service purchases as permissive service and as qualified and non-qualified service.)

Voluntary Employee Contributions for Service Purchases	415(c) Testing or 415(n) Testing
In-service transfers from DC Plans (401(k), SPSP)	415(c) limits (including 415(n) modified limits) do not apply. Regular 415(b) limits should be applied at distribution.
Lump sum after-tax employee contributions and installment contracts for after-tax contributions if for non-permissive service or for nonqualified permissive service credit in excess of limits	415(c) limits apply (lesser of \$40,000 (adjusted) or 100% compensation in the year of purchase). These will be tested on an exception basis.
Lump sum after-tax employee contributions and installment contracts for after-tax contributions if for permissive service	415(n) limits apply. Therefore, purchase will be tested under modified 415(b) limits. However, SDCERS may prospectively implement modified 415(c) testing procedure.
Picked-up employee contributions for installment contracts Note: A favorable IRS private letter ruling is the mechanism for obtaining approval for a pick-up of employee contributions for a service purchase.	415(c) limits (including 415(n) modified limits) do not apply. Regular 415(b) limits should be applied at distribution.
Lump sum rollovers from eligible plans (401(a), 457(b), 403(b), 401(k), 403(a) and IRAs)	415(c) limits (including 415(n) modified limits) do not apply. Rollovers only after separation from service except IRAs.
Repayment of refunded contributions	Under 415(c)(3), 415(c) limits will not apply. 415(b) limits will apply at distribution.
Lump sum transfers from 457(b)/403(b) plans	Limited to permissive service credit and restoration of service. 415(c) limits will not apply. 415(b) limits will apply. See Rule 10.60.

It is our understanding from SDCERS staff that the vast majority of service purchases are made by plan-to-plan transfer from the Employers' plans. However, all of the other mechanisms are used to some extent, including after-tax payments.

#### F. TESTING OF USERRA SERVICE PURCHASES

SDMC § 24.1309 addresses purchase of retirement credit for service in the armed forces. The provision specifies that for purchases made pursuant to a leave due to military service, the payment is treated as an annual addition for the limitation year to which it relates. In order to provide appropriate treatment of USERRA service purchases, SDCERS will need to work with Employers to determine USERRA eligibility. The problem of accurate USERRA reporting may be limited to only a few SDCERS members because most SDCERS members who are called to

military service receive differential pay. It is the City's practice to deduct the member's contribution from the differential pay on a picked-up basis. As a result, most SDCERS members retiring from USERRA-covered service to employment do not need to make any contributions for the USERRA leave period.

**CIRCULAR 230 DISCLOSURE**

Except to the extent that this advice concerns the qualification of any qualified plan, to ensure compliance with recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including any attachments, is not intended or written by us to be used, and cannot be used, by anyone for the purpose of avoiding federal tax penalties that may be imposed by the federal government or for promoting, marketing, or recommending to another party any tax-related matters addressed herein.

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Exhibit A: Cheiron Report on Retrospective 415(b) Testing (Revised 11/27/07)

## Exhibit A: Report on Retrospective 415(b) Testing

### SDCERS Retroactive 415 Testing

The following is a description of Cheiron's detailed procedures for conducting retroactive testing of SDCERS for 415(b) violations and determination of the amount of excess benefits subject to payment by the City of San Diego under the VCP submission. It includes an exhibit with line by line demonstrations of the retroactive testing procedure applied. The third column of this exhibit maps the testing procedure with the Internal Revenue Code section, corresponding regulation or revenue ruling. The fourth and fifth columns to the right include two examples. We have also include an exhibit of multiple years for a single participant that illustrates how the COLA adjusted limit and benefit change over time and how a participant's retirement benefit could grow under the limit.

The table is also color coded to identify those elements of the testing that are basic data, benefits, benefit conversions, limitation calculations and testing results.

#### Definition of the testing benefits

The first step in the testing is identification and gathering of the participant data and benefit information to conduct the test. These tests were conducted on all current retirees including disabled retirees as of June 30, 2007 who we expected to receive benefits in excess of the 415(b) defined benefit dollar limits (the Limit) as defined for government plans. The testing group was isolated by including any retiree whose benefit was within 80% of the estimated 415(b) dollar limit along with the basic participant data, the benefit data includes:

- The base benefit which refers to the regular benefit defined in the Municipal Code that is provided as a monthly amount, and includes benefits funded by the City and participants through pre-tax employee pick-up contributions. The participant contributions are defined in three parts: the annuity, the COLA annuity (cost of living adjustment), and the surviving spouse annuity, which is an additional benefit for participants who elect a single life annuity in lieu of a qualified joint and survivor annuity (QJSA).
- The base benefit is subject to COLA and the amount of the current monthly benefit that represents the COLA granted from retirement through June 30, 2007 were provided as a separate monthly amount (COLA pension).
- Corbett Settlement for those participants in the settlement class, which represents an additional benefit also subject to COLA payable annually, but just once per year as payments are contingent on certain investment performance benchmarks – for testing we assume this benefit, has been paid in each year from retirement through June 30, 2007.

- 13<sup>th</sup> check which is another contingent benefit that is based on a fixed amount per years of service and is not subject to annual COLA – we assumed this was always paid.
- DROP benefits are included either as an account balance or as an annuity if the payout election was as a life annuity form of payment. The account balances were provided as two data elements - the DROP contributions and DROP interest - which were aggregated to equal the DROP account. The DROP account can be paid out in various forms, but for testing we classified the participant election as either a life annuity form or a lump sum. If a lump sum was paid (or assumed), we then annuitized the lump sum value in accordance with the descriptions below.
- Offset benefits, defined as qualified rollovers used to purchase additional benefits and any post-tax employee contributions were converted to life annuity equivalents.
- The COLA benefit is a CPI-based formula with a cap of 2.0% with the provision for banking excess CPI increases for future years when the CPI is below the cap – it is our understanding there is only one year the full 2.0% was not paid. We were provided with the COLA increases to date and for all other purposes of defining benefits as increasing, we assumed the 2.0% cap is applied every year on a compounded basis.

Among all of the benefits gathered, the 13<sup>th</sup> check and the DROP are the only two benefit income sources that are not subject to the annual COLA. The balance of the benefits defined above will increase by the COLA each year.

#### **Testing criteria**

We used a number of triggers to define what benefits are tested, and what adjustments are used to conform the benefit to the appropriate 415(b) dollar limit. These triggers include:

- Did the participant have 15 or more years of qualified service as a safety officer to be eligible for the more liberal 415(b)(2)(G) and (H) limits?
- Is the form of retirement a life annuity or qualified joint and survivor annuity (which is not subject to form adjustment)?
- Does the participant have 10 or more years of participation and therefore is not subject to a prorated limit?

#### **Actuarial Adjustments**

We used the increasing form of benefit for determining the benefit payable and the 415(b) dollar limit. This approach provides SDCERS with the net amount of benefit payable from the System.

For the SDCERS plan assumptions, we used the blended 50/50 1983 Group Annuity Mortality tables and an 8.0% interest assumption for all retroactive testing years. These factors were used and tested against the Internal Revenue Code assumptions defined in section 415(b)(2)(B) and (E) (referred to as statutory assumptions), in accordance with

Revenue Ruling 98-1 and 2001-62 to determine the appropriate assumptions in effect at the time of retirement. If the retiree participated in the DROP, we referred to the form of payout and if it was a non-life form of distribution, we applied the section 417(e)(3) assumptions in lieu of the Plan and/or statutory assumptions. If it was in a life annuity we standardized the benefit using the Plan and/or statutory assumptions. The appropriate assumption was determined for each participant potentially subject to the limits, to determine the largest benefit after application of the actuarial equivalence. The break points for the different rulings of appropriate assumptions to use are:

- Prior to calendar 2002, the plan assumptions were tested against the same mortality table and 5.0% or 417(e)(3) applicable interest rate, based on normal retirement defined as Social Security normal retirement age.
- For factors during 2002 we used the same mortality table above, 5.0% or 417(e)(3) applicable interest rate without adjustment for retirement age between ages 62 and 65.
- For factors after December 31, 2002 we used 5.0% or 417(e)(3) applicable interest rate and GAR94 Mortality Tables projected to 2002 using AA projection scales to compare with the assumptions above without adjustment for retirement age between ages 62 through 65.

In each case, the assumptions used are those that result in the largest benefit for testing.

If a participant with a DROP benefit is subject to the 417(e)(3) applicable mortality and interest rates then only these rates were used and applied to both the standardization of the form of benefit and to adjustments to the limit for an increasing benefit form.

These adjustment factors were used for the following conversions:

- Conversion of form of benefits that were not in pay status as single life annuity or qualified joint and survivor to single life annuity.
- Conversion of benefits to increasing benefit using a 2.0% annual increase rate.
- Conversion of DROP benefits based on the elected form of payment
- Conversion of rollovers and post-tax employee contributions to appropriate annuity forms to allow for aggregation of all benefits to the same benefit form for testing.
- Conversion of the 415(b) limit under the appropriate law in effect on the date of actual retirement, and after adjustment for age at retirement, to an increasing form of benefit using the appropriate assumptions defined for conversion of benefits to a standard form of payment, to determine the amount of net benefit that can not be paid from SDCERS.

In making adjustments from a level life annuity form to an increasing benefit to reflect the automatic COLA, we redefined the interest rate for determining appropriate annuity conversion factors as the ratio of the appropriate interest assumption over 1.02 (for example if the plan interest rate was appropriate then the factor used to convert a benefit

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to an increasing form was determined by using a 5.88% interest rate [ $1.08/1.02 - 1 = .0588$ ]).

### Testing procedure

The appropriate limit is determined based on the participant's exact age at the end of the first limitation year of retirement. The limit is defined as the prorated limits in effect for the two calendar years bridged by the limitation year ending June 30<sup>th</sup>. The limit is age adjusted and then converted to an equivalent increasing annuity at the rate of 2.0%.

In performing the adjustment to the Limit to an increasing form, if the retiree was not participating in the DROP and therefore not subject to 417(e)(3) assumptions, the adjusted limit was determined under the plan and statutory assumptions and the lower of the two Limit values was used for testing.

If the participant had a DROP benefit payable in a non-life annuity form, then the Limit was converted to an increasing annuity form using the 417(e)(3) applicable interest rate in effect for the month preceding the participant's annuity starting date.

The increasing equivalent DROP annuity is then deducted from the Limit, on the theory that if taken as a lump sum the full future benefit attributable to the DROP will always be paid. In no circumstance was the annuitized value of the DROP greater than the adjusted 415(b) dollar limit. The remaining limit is then compared to the balance of the benefits that will be actually paid during the year.

This actual benefit payable is equal to the sum of the base benefit, Corbett Settlement and adjusted 13<sup>th</sup> check benefit (to be an equivalent increasing benefit), net of any rollover or post-tax employee contribution equivalent annuities.

The net difference between the adjusted increasing net 415(b) limit and the benefit payable is the portion that is not payable by SDCERS. This net result provides us with the information and in a form that can be used to reduce the benefits payable from SDCERS in compliance with Section 415(b) of the Internal Revenue Code with all the amplifying regulations and rulings for the first year of retirement.

In the first year of retirement for a participant who is found to have an annual benefit in excess of their Limit, the actual benefits received during a limitation year are applied to the full Limit for that year. If the fractional year of receipts is less than the Limit, no excess amount was defined for the first limitation year in which the participant retired. For all subsequent years the excess amount was defined as the amount received in that full year over the full year's Limit.

These calculations are prepared every year from actual retirement to June 30, 2007 or until the benefit has fallen below the 415(b) dollar limit as a function of the increases from the 415(b) limit increase for indexing and 2.0% COLA adjustment. For purposes of the annual tests the assumptions are fixed at the date of retirement for making future

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adjustments to the Limit. The Limit itself, to which the fixed assumptions are applied, will increase as specified by the IRS

For purposes of the VCP submission and determination of the amount due from the City to cover the accumulated excess benefits paid from the fund. The amounts due from the City only include excess amounts since 1995 as part of this application. The annual excess amounts were rolled forward from the end of the limitation year in which the benefits were paid to June 30, 2007 using an annual interest rate of 8.0%.

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Exhibit B: Cheiron Report on Prospective 415 (b) Testing (Revised 12/6/07)

**Exhibit B: Cheiron Procedures on Prospective 415(b) Testing****San Diego City Employees Retirement System****Prospective 415(b) Testing**

Prospective testing will be conducted first by SDCERS through a screening process that will combine detailed information provided through Pension Gold and a calculator developed to incorporate the various benefits to be included as defined benefits. Cheiron will be involved in verification of those benefits considered within a reasonable range of the maximum limitations to verify any adjustments to be made.

The calculator is currently designed to make adjustments to benefit forms and test against the 415(b) dollar limit (the Limit) to identify any participant who is entitled to benefits that are 70% or greater than their age specific Limit. That information is then currently forwarded to Cheiron for additional testing and application of the procedures defined below. It is anticipated in time with the understanding of the appropriate procedures that the calculator quality will improve and reduce the testing margin (70%) and number of participants sent subject to Cheiron for additional testing.

The process will be similar to the retrospective approach. We see no significant changes under the Final Regulations other than those that may define future applicable interest and mortality assumptions for conversion of benefit forms. We do anticipate that complete data will be available for the inclusion of more accurate information on the nature of funds used in the purchase of service, rollover amounts and post tax employee contributions for offset in the determination of the benefit subject to testing.

It is anticipated the calculator will also be adjusted for the potential changes to the testing procedure as a function of changes in defined limitation year (moving to calendar year effective January 1, 2009).

The following is a description of procedures for conducting prospective testing of SDCERS for 415(b) violations identified through the application of the calculator at the time of retirement application.

**Definition of the testing benefits**

The first step in the testing is identification and gathering of the participant data and benefit information to conduct the test which will be output from the calculator. The benefit data includes:

- The base benefit which refers to the regular benefit defined in the Municipal Code that is provided as a monthly amount, and includes benefits funded by the City and participants through pre-tax employee pick-up contributions. The participant contributions are defined in three parts: the annuity, the COLA annuity (cost of living adjustment), and the surviving spouse annuity,

which is an additional benefit for participants who elect a single life annuity in lieu of a qualified joint and survivor annuity (QJSA).

- The base benefit is subject to COLA for DROP retirees. The COLA is calculated from the date of DROP entry so the amount of the current monthly benefit represents the COLA granted from DROP entry to actual retirement date and is provided as a separate monthly amount (COLA pension) All other new retirees should have no COLA pension amounts at testing.
- Corbett Settlement for those participants in the settlement class, which represents an additional benefit also subject to COLA payable annually, but just once per year as payments are contingent on certain investment performance benchmarks - for testing we assume this benefit is payable every year.
- 13<sup>th</sup> check which is another contingent benefit that is based on a fixed amount per years of service and is not subject to annual COLA - we assumed this is payable every year.
- DROP benefits are included either as an account balance or as an annuity if the payout election was as a life annuity form of payment. The account balances were provided as two data elements - the DROP contributions and DROP interest - which were aggregated to equal the DROP account. The DROP account can be paid out in various forms, but for testing we classified the participant election as either a life annuity form or a lump sum. If a lump sum was paid (or assumed), we then annuitized the lump sum value in accordance with the descriptions below.
- Offset benefits, defined as qualified rollovers used to purchase additional benefits were converted to life annuity equivalents.
- The COLA benefit is a CPI-based formula with a cap of 2.0% with the provision for banking excess CPI increases for future years when the CPI is below the cap. We will be provided with the COLA increases to date and for all other purposes of defining benefits as increasing, we assumed the 2.0% cap is applied every year on a compounded basis.

Among all of the benefits gathered, the 13<sup>th</sup> check and the DROP are the only two benefit income sources that are not subject to the annual COLA. The balance of the benefits defined above will increase by the COLA each year.

### Testing criteria

We will use a number of triggers to define what benefits are tested, and what adjustments are used to convert the benefit to the appropriate 415(b) dollar limit. These triggers include:

- Did the participant have 15 or more years of qualified service as a safety officer to be eligible for the more liberal 415(b)(2)(G) and (H) limits?
- Is the form of retirement a life annuity or qualified joint and survivor annuity (which is not subject to form adjustment)?
- Does the participant have 10 or more years of participation and therefore is not subject to a prorated limit?

### Actuarial Adjustments

We will use the increasing form of benefit for determining the benefit payable and the 415(b) dollar limit. This approach provides SDCERS with the net amount of benefit payable from the System.

- For the SDCERS plan assumptions, we will use the blended 50/50 1983 Group Annuity Mortality tables and an 8.0% interest assumption for all retroactive testing years. These factors were used and tested against the Internal Revenue Code assumptions defined in section 415(b)(2)(B) and (E) (referred to as statutory assumptions), in accordance with Revenue Ruling 98-1 and 2001-62 to determine the appropriate assumptions in effect at the time of retirement.
- If the retiree participated in the DROP, we referred to the form of payout and if it was a non-life form of distribution, we will apply the new rules that call for testing the conversion of the account balance under (1) the plan assumptions, (2) using 5.5% and applicable mortality tables under 417(e)-1(d)(2) or (3) using the applicable interest and mortality assumptions divided by 1.05. If it was in a life annuity we standardized the benefit using the Plan and/or statutory assumptions. The appropriate assumption is determined for the participant subject to the limits, to determine the largest benefit after application of the actuarial equivalence.
- The Statutory factors currently in effect are 5.0% or 417(e)(3) applicable interest rate and GAR94 Mortality Tables projected to 2002 using AA projection scales to compare with the assumptions above without adjustment for retirement age between ages 62 through 65.

In each case, the assumptions used are those that result in the largest benefit for testing.

If a participant with a DROP benefit is subject to the applicable mortality and interest rates as described in the 2<sup>nd</sup> bullet above, then only these rates were used and applied to both the standardization of the form of benefit and to adjustments to the limit for an increasing benefit form.

These adjustment factors will be used for the following conversions:

- Conversion of form of benefits that were not in pay status as single life annuity or qualified joint and survivor to single life annuity.
- Conversion of benefits to increasing benefit using a 2.0% annual increase rate.
- Conversion of DROP benefits based on the elected form of payment
- Conversion of rollovers to appropriate annuity forms to allow for aggregation of all benefits to the same benefit form for testing.
- Conversion of the 415(b) limit under the appropriate law in effect on the date of actual retirement, and after adjustment for age at retirement, to an increasing form of benefit using the appropriate assumptions defined for

conversion of benefits to a standard form of payment, to determine the amount of net benefit that can not be paid from SDCERS.

In making adjustments from a level life annuity form to an increasing benefit to reflect the automatic COLA, we redefined the interest rate for determining appropriate annuity conversion factors as the ratio of the appropriate interest assumption over 1.02 (for example if the plan interest rate was appropriate then the factor used to convert a benefit to an increasing form was determined by using a 5.88% interest rate  $[1.08/1.02 - 1 = .0588]$ ).

#### Testing procedure

The appropriate limit is determined based on the participant's exact age at the end of the first limitation year of retirement. The limit is defined as the prorated limits in effect for the two calendar years bridged by the limitation year ending June 30<sup>th</sup>. The limit is age adjusted and then converted to an equivalent increasing annuity at the rate of 2.0%.

In performing the adjustment to the Limit to an increasing form, if the retiree was not participating in the DROP and therefore not subject to 417(e)(3) assumptions, the adjusted limit will be determined under the plan and statutory assumptions and the lower of the two Limit values will be used for testing.

If the participant had a DROP benefit payable in a non-life annuity form, then the Limit will be converted to an increasing annuity form using the 417(e)(3) applicable interest rate in effect for the month preceding the participant's annuity starting date.

The increasing equivalent DROP annuity is then deducted from the Limit, on the theory that if taken as a lump sum the full future benefit attributable to the DROP will always be paid. The remaining limit is then compared to the balance of the benefits that will be actually paid during the year.

This actual benefit payable is equal to the sum of the base benefit, Corbett Settlement and adjusted 13<sup>th</sup> check benefit (to be an equivalent increasing benefit), net of any rollover or post-tax employee contribution equivalent annuities.

The net difference between the adjusted increasing net 415(b) limit and the benefit payable is the portion that is not payable by SDCERS. This net result provides us with the information and in a form that can be used to reduce the benefits payable from SDCERS in compliance with Section 415(b) of the Internal Revenue Code with all the amplifying regulations and rulings for the first year of retirement.

In the first year of retirement for a participant who is found to have an annual benefit in excess of their Limit, the actual benefits received during a limitation year are applied to the full Limit for that year. If the fractional year of receipts is less than the Limit, no excess amount would be defined for the first limitation year in which the participant retires. For all other subsequent years the excess amount would be defined as the amount received during the year over the full year's Limit.

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These calculations will be prepared every year until the benefit has fallen below the 415(b) dollar limit as a function of the increases from the 415(b) limit increase for indexing and 2.0% COLA adjustment. For purposes of the annual tests the assumptions are fixed at the date of retirement for making future adjustments to the Limit. The Limit itself, to which the assumptions are applied, will increase as specified by the IRS.