

SDCERS NAVIGANT REPORT COMMITTEE/STAKEHOLDER MEETING

June 14., 2006 - Meeting Notes by Virginia Silverman

1. INTRODUCTION/PRELIMINARY

Committee members in attendance: Mark Sullivan (Chair), Thomas Hebrank, William Sheffler, Richard Kipperman, Wayne Kennedy, and Peter Preovolos (SDCERS Board President, ex officio member).

Also in attendance: Joe Flynn, SDCERS Board Member/Retiree Representative; Navigant Stakeholder Representatives Jim Clem (Retired Fire & Police), Virginia Silverman (CSDREA) and Judy Italiano (MEA). Several City Hall staffers were also in attendance.

Chairman Mark Sullivan opened the meeting with an overview of the need by SDCERS and the City for compliance with IRS rules, commenting that the most significant parts of the Navigant Report dealt with issues of IRS compliance. He said, some of the issues have already been addressed at previous Navigant meetings (Presidential benefit, DROP distribution rules). He said the sole purpose of IRS compliance actions is to preserve tax qualified (tax exempt) status of the pension fund.

Today's topic, retiree health insurance, is being discussed because it is currently in violation of IRS rules, which prohibit the use of public pension funds to pay for retiree health benefits or for the administration of retiree health benefits.. Over the years SDCERS has paid for a substantial percentage of retiree health benefits, and administrative costs, and therein is the problem

Sullivan introduced attorneys from the Ice Miller law firm/tax specialists, who have previously presented findings and recommendations on the other two IRS compliance issues. He said that Ice Miller and SDCERS staff have spent many hours going through files to reconstruct expenditures and to provide findings and recommendations for a filing with the IRS on retiree health benefits.

2. RECOMMENDED FILING WITH IRS RE: FUNDING, ACCOUNTING AND PAYMENT OF CITY OF SAN DIEGO RETIREE HEALTH BENEFITS

Ice Miller Attorneys, Terry Mumford and Mary Beth Braitman, began their presentation by commenting that this was 'Round Three' of IRS Filings. They said their review and analysis of retiree health benefits is divided into four critical time periods, when different rules and funding scenarios applied.

In addition, Ice Miller detailed three critical periods for funding of administrative expenses for retiree health benefits.

A. Funding for Retiree Health Benefits – Four Critical Periods

First Period – July 1, 1982 through June 20, 1991

In January 1992, (concurrent with the vote to leave Social Security System), Retiree Health Benefits were established, with funding to come directly from Surplus Undistributed Earnings (the 'Waterfall'). During this period, \$ 8,227,271 was paid for retiree medical benefits from the Waterfall. This funding method was established by City Council Ordinance 0-16649..

No employer contributions were made during this period to support these benefits payments; and

therefore, the \$8.2 million was an impermissible use of pension fund assets.

Second Period – July 1, 1991 through June 30, 1994

In May, 1992 the City Council adopted Ordinance 0-17770, which deleted retiree health payments from the Waterfall. Instead, the City directly paid an up-front sum of \$25,300,000 to a separate retiree health benefits fund (66013).

Retiree health benefits paid during this period were \$10,014,865. The net surplus funding at the end of this Second Period was \$14,084,195.

Third Period – July 1, 1994 through June 30, 1997

During this three-year period, the previous ordinance and funding method remained in effect until the balance of the unused funding (\$14,084,185) was spent.

Fourth Period – July 1, 1997 through June 30, 2005

Ordinance No.0-18383, passed in February 1997, added payments for retiree health benefits back into the Waterfall, effective July 1, 1997. The ordinance also provided for a 401(h) account, which is permissible under IRS rules to pay for retiree health benefits.

This Waterfall funding method continued until February 2005, during which \$63,462,590 was paid in health benefits. During certain years in this period, the City designated portions of the employer contributions to the pension fund to instead be credited to the 401(h) account to pay retiree health benefits. This diversion to the 401(h) accounts contributed to the underfunding of the pension fund.

As of February, 2005, the City began directly funding retiree health benefits.

Ice Miller Analysis and Recommendations for Proposal to IRS on Retiree Health Benefits Funding

Based on Navigant Report conclusions and year-to-year research, SDCERS staff determined that \$96,989,861 was spent on retiree health benefits between 1982 and 2005. Of this total, \$8,227,271 was spent directly from SDCERS; \$25,300,000 was paid directly by the City (outside the pension fund); and \$63,462,590 was paid from the 401(h) account (with City contributions going to the 401(h) account instead of staying in the pension fund).

Given the above funding, Ice Miller recommended the following position as reasonable to present to the IRS:

- . As of July 1, 1997 there was a valid 401(h) account established by the City in the Municipal Code;
- . The City was permitted to fund it under IRS Code Section 401(h) and Treasury regulations as part of a qualified plan;
- . The City designated its contributions to the 401(h) account pursuant to federal and local law, and;
- . SDCERS credited the designated amounts to the 401(h) account.

Ice Miller concluded that it would be reasonable for the IRS to approve a plan for SDCERS to bill the City for the \$8,227,271 spent directly by SDCERS (First Period), with appropriate interest of \$23,391,085 on that amount. Under this plan, the total reimbursement due from the City to SDCERS would be \$31,618,356 (through the end of FY 2006). Ice Miller would also propose to the IRS that a time period be established for the repayment by the City, for example five years. If paid over time,

B. Administrative Expenses for Retiree Health Benefits – Three Critical Periods

First Period - July 1, 1982 through June 30, 1991

There were no time records or expenses which could be found for this time period/ Therefore SDCERS staff estimated that that the percentage of total expenses to administer retiree health for the first subsequent year records were kept would be a reasonable percentage to use – 1.037%. Based on this estimate of administrative costs as a percent of total health expenditures, SDCERS staff calculated that \$79,125 should have been charged to the City for administrative expenses during these years. (No reimbursements by the City for administrative costs were made during this time)

Second Period – July 1, 1991 through June 30, 1999

During these years, records show that the City reimbursed SDCERS for administrative expenses in the amount of \$818,560, which reflect a reasonable expense allocation and reimbursement. Total expenditures for health benefits were approximately \$10 million during this period.

Third Period – July 1, 1999 through June 30, 2005

During this period records were kept which reflect a reasonable expense allocation of \$1,444,306 for administration. However no reimbursement was received from the City.

Ice Miller Recommendations for Proposal to IRS on Retiree Health Administrative Expenses

Ice Miller staff said that SDCERS staff had determined that a total of \$2,341,992 was paid from SDCERS pension assets for administrative expenses between 1982 and 2006, and that the City reimbursed SDCERS only \$818,561. Therefore, the City still owes \$1,523,431 for administrative expenses.

Ice Miller recommended that SDCERS should bill that amount to the City now, with appropriate interest of \$688,464, for a total of \$2,211,895 through FY 2006. This could also be proposed to the IRS for repayment over a time period, with additional interest calculated for the repayment period.

Ice Miller also recommended that beginning with July 1, 2006, SDCERS should account for and bill the City in advance each year for anticipated administrative costs for the retiree health program.

3. QUESTIONS AND COMMENTS

Committee Member William Sheffler commented that under the municipal code, retiree health benefits are still a liability of the pension fund even though the City is currently paying the costs. He asked if this created a conflict. Roxanne Story Parks (SDCERS Interim Counsel) said that the muni code needs to be amended, but the City Council has to act.

General discussion on this issue followed by Committee members and staff. (Virginia Silverman commented that there was a 1996 charter amendment approved by the voters which permitted a transfer of funding responsibility for retiree health benefits from the City to SDCERS. No comment from SDCERS staff or the committee on this).

Regarding administration of health benefits, Mark Sullivan said that SDCERS should just go ahead and bill the City, and if they refuse pay, take them to court. Thomas Hebrank asked if the plan sponsor (City) has made any comments on this (no answer).

Also on the administration of health benefits, Wayne Kennedy commented on the large difference in the percentages applied to determine administrative costs between the First Period and thereafter. (It was only 1.037% for the first period; more than 8% for subsequent periods). The answer given was that health benefits were more complex and that there were more retirees receiving benefits.

Virginia Silverman spoke on behalf of CSDREA in support of SDCERS continuing to administer the retiree health benefits. Apparently that is the intent of SDCERS, and is assumed by Ice Miller.

4. APPROVAL OF PROPOSAL/NEXT MEETING

Following the discussion and questions, Navigant Committee unanimously approved the recommendations by Ice Miller for submission to the IRS. (This recommendation went to the full SDCERS Board for action on Friday, June 16, and the Board also approved the Ice Miller proposal unanimously, 12-0).

Chairman Mark Sullivan announced the next Navigant Report Committee meeting will be on Wednesday, July 12, 2006 at 1:00 p.m. in the SDCERS Meeting Room. The agenda and topic for discussion for the meeting will be posted on the SDCERS website – www.sdcers.org – 72 hours prior to the meeting.