STATE OF MICHIGAN

IN THE SUPREME COURT

WAYNE COUNTY EMPLOYEES RETIREMENT SYSTEM and **WAYNE COUNTY RETIREMENT COMMISSION,**

Plaintiffs/Counter-Defendants/Appellees,

v

CHARTER COUNTY OF WAYNE,

Defendant/Counter-Plaintiff/Appellant,

and

WAYNE COUNTY BOARD OF COMMISSIONERS,

Defendant/Appellant.

SC: 147296

COA: 308096
Wayne CC: 10-013013-AW
Hon. Michael F. Sapala

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COUNTER-STATEMENT OF QUESTIONS PRESENTED

Whether the Court of Appeals erred in holding that provisions of Wayne County Enrolled Ordinance 2010-514 violate the Public Employee Retirement System Investment Act, MCL 38.1132 et seq ("PERSIA"), because they purported to permit or require:

- the County not to pay its entire Annual Required Contribution (ARC);
- the Trustees to move dedicated Inflation Equity Fund trust assets out of the IEF reserve for a purpose other than distribution of 13th checks;
- the use of IEF trust funds to offset the County's ARC, in violation of the exclusive benefit rule; and
- the Trustees to engage in a transaction for the benefit of the County for less than adequate consideration, in violation of the prohibited transaction rule?

The Court of Appeals says no.

The Retirement System says no.

Whether any constitution, statute, or charter provision gives the County the power to direct the movement of trust funds from the Retirement System's IEF reserve?

The Court of Appeals says no.

The Retirement System says no.

Whether the County's failure to pay its ARC violates the Michigan Constitution's Pension Clause, Const 1963, art 9, §24?

The Court of Appeals did not answer this question.

The Retirement System says yes.

INTRODUCTION

Wayne County does not have the power to move funds from the Retirement System's Inflation Equity Fund (IEF). Enacting an ordinance that directs the Retirement System to move funds from its IEF reserve results in a "transaction" that violates the Public Employee Retirement System Investment Act (PERSIA), even if the County had made its Annual Required Contribution (ARC). These are the answers to the questions posed by this Court in its order granting leave to appeal.

The PERSIA violations in this case extend beyond improper interference with the Retirement System's governance of its trust assets, because the County in fact did not pay its full ARC in 2010 and 2011. It shortchanged the Retirement System by $32 million dollars. There were "prohibited transaction" and "exclusive benefit" violations, even without the ARC shortfall, because the County's use of IEF funds to bolster the defined benefit assets would by itself have reduced the ARC by about two million dollars, thus benefiting the County. As it happened, the violations were more serious, violating both PERSIA and the second clause of Const 1963, art 9, §24.

The County says that its power to move assets from the IEF reserve is the same power it used to create the IEF benefit in the first place (County Brief 20). This is inaccurate. To the extent that it used its power to enact prospective changes to the IEF, the source of its power *is* the same and those changes were respected by the Court of Appeals, which affirmed the trial court as to all such changes in the 2010 Ordinance that did not violate PERSIA. They are not at issue here. This Court's question identified the real issue, which is the source and nature of the power to manage and control the assets of a public retirement system. Under PERSIA, the Wayne County Charter, and the Wayne County Retirement Ordinance, all power to manage and control Retirement System assets resides exclusively with the trustees who sit on the Retirement

Commission. The County has two seats on that Commission, but does not control it. This independent control of public retirement funds, beyond the control of the plan sponsor, is a chief difference between public pension law and ERISA, the law governing private employer pensions.

The County's inability to act with respect to assets once they have been received by the Retirement System is dispositive in this case. The result reached for that reason is further bolstered by consideration of the Court's other two questions.

If the County had the authority to move assets from the IEF reserve, and had done so while still paying its ARC—its Annual Required Contribution—there would still have been a PERSIA violation. As the italics indicate, the first premise in this question is false; the County lacks that authority under PERSIA's governance rules, so there is a PERSIA violation without regard to whether the ARC is or is not paid in full. That aside, however, the County's ARC would have had to have been recalculated by the actuaries to account for an additional $32 million in defined benefit assets, improving the funding level by about one percent. Although the calculation is not in the record, the County concedes that this would benefit it (County Brief 33). The Retirement System's actuaries calculate that the benefit would amount to almost two million dollars, thus violating PERSIA's exclusive benefit rule.

This Court's third question is directed to PERSIA's prohibited transaction rule. The County's position is simple—nothing in MCL 38.1133(6) (now subsection 8) applies to an "intra-system transfer of assets" (County Brief 44), so there was no transaction. This pinched, narrow reading of PERSIA is completely inconsistent with its plain language and purpose. The Court asks about subsection (6) (again, now (8)) in general, but the County writes as though only (6)(c) existed. Subsection (6)(d), for example, shows that even a use by the County of the

Retirement System's facilities without adequate consideration—something that does not require any assets to leave the system—would be a "prohibited transaction." Which is not to say that the County's movement of $32 million in IEF assets is not clearly a "transaction" even if only the language of (6)(c) is considered. By its own terms, there need not be a "transfer to" the County, as long as there is a "use by or for the benefit of" the County. These two alternatives are listed in the disjunctive. The County made "use" of the IEF assets to avoid paying its full ARC. This was a direct "use" of trust assets "for the benefit of" the County. Moreover, all of the subsections of (6) are preceded by the phrase "either directly or indirectly," because PERSIA is intended to prohibit not just those transactions that are obviously and directly illegal or improper, but also those transactions designed to indirectly achieve the same prohibited results. This was such a transaction.

COUNTER-STATEMENT OF FACTS

Background

The identity, composition and nature of the parties is not disputed in this case and is carefully detailed in the opinion of the Court of Appeals (App 286a-291a) and the parties' prior briefs. The Wayne County Employees' Retirement System is a public body established to provide retirement income and benefits to eligible Charter County of Wayne employees and their survivors. The Wayne County Retirement Commission, a public body empowered by statute, charter and ordinance, is solely responsible for administering and managing the Retirement System. It consists of eight Trustees, six of whom are elected—four active County employees and two retired employees. The remaining two are ex-officio County members—the County Commission Chair and the Wayne County Executive or his designee.

The Retirement System's trustees are vested by state and county law—detailed in the first section of argument, below—with fiduciary responsibility for the administration and operation of the Retirement System and the sole management of its assets. The Retirement System is comprised of a defined contribution plan and several defined benefit plans. The defined benefit plans include a County-created benefit provision that provides a measure of post-retirement relief from the effects of inflation on a fixed pension over time, namely the Inflation Equity Fund, from which are paid the annual "13th checks," as explained in detail by the Court of Appeals (App 288a-291a). All members of the defined benefit plans are eligible for the 13th check unless the benefit was bargained away through collective bargaining. An example of the language used in most CBAs is this: "Employees in the Hybrid Retirement Plan shall be eligible for post retirement cost-of-living adjustments in the form of distributions from the Reserve for Inflation Equity" (*e.g.*, App 236a).[1]

The Retirement System disagrees with the County's description of 13th checks as "discretionary bonus checks" (County Brief at 5). The word "bonus" does not appear in the Retirement Ordinance itself, or in any of the collective bargaining agreements, or in any Retirement System summaries or reports. In the same vein, the County says that these "bonus" checks are to be paid with "excess investment earnings generated during economic boom times" (*id.* at 8). Nothing of the sort appears in any version of the IEF Ordinance. The County supports the "boom times" assertion by citing to the Court of Appeals opinion, but nothing in the opinion supports the assertion.

1 When the County and its local unions negotiated this subject over the years in the collective bargaining process, if an employee group decided to forgo the IEF program, the CBA would use language like this: "All employees hired on or after October 1, 2008 shall not be eligible for a 13th check upon retirement" (App 238a). This "eligibility language," adopting or excluding the IEF program, is summarized in table form in a County exhibit (App 236a-240a, third column). Overall, the IEF program had more than 6,000 participants every year from 1986 through 1999, and more than 5,500 every year since then (App171a-174a).

Additionally, "bonus" is not an apt label because the 13th check is not a reward for superior service but, as the Court of Appeals noted, a program "to address the impact of inflation on the buying power of pension income" (App 288a). The County says that, although the Court of Appeals "implied" this COLA-like purpose, the purpose is irrelevant (County Brief at 7 n.6). Irrelevant or not, the County has thought it important throughout this litigation to use and stress the term "bonus" at every opportunity. It continues to do so. Moreover, the Court of Appeals did not "imply" this COLA-replacement purpose; it was stated as fact (App 288a). The circuit court stated it as the County's position in its two summary disposition opinions (Opinion of 9/29/2011, App 276a; Opinion of 12/20/2011 at 3, App 150b). This always has been the Retirement System's position too, and it introduced extensive evidence in the circuit court to establish the fact (summarized at length, with supporting record references, in the System's previous briefs). While the circuit court ultimately concluded—erroneously, but now irrelevantly—under MCR 2.116(C)(10) that there was "insufficient evidence" of this purpose underlying enactment of the IEF program (App 277a), the County presumably now views that as "irrelevant."

The IEF benefit was created by the County, not the Retirement System or its Trustees. The County, in conjunction with the unions representing many of its employees, negotiates terms, enters into contracts, and enacts or amends ordinances to provide retirement and other benefits.[2] That is how the IEF came to be. The Retirement System, through its Trustees, administers benefit programs like the IEF and manages the assets it holds in trust for those programs. Recognition of the Trustees' discretion is built into the IEF Ordinance, WCCO §141-32 (App 338a is the IEF Ordinance as amended by the 2010 Ordinance at issue in this case; the IEF

[2] As discussed *infra* at 19 n.11, retirement benefits are a mandatory subject for collective bargaining. Under Michigan's Public Employment Relations Act (PERA), it is an unfair labor practice for a governmental employer to change such benefits unilaterally.

Ordinance as it existed before the amendment is at Tab B). The Trustees have *invariably* exercised their discretion in favor of distributing a 13th check (App 291a), consistent with their fiduciary duties under PERSIA. Under the IEF Ordinance, *only* the Trustees have any discretion with respect to the administration of the assets in the IEF reserve. The County has no such discretion. It is conceded by the County that the assets in the IEF reserve, like all assets in the Retirement System, are trust funds. Under PERSIA, the Wayne County Charter, the Retirement Ordinance, and all Michigan case law, all of these assets are administered, managed, and controlled by the Trustees of the Retirement System.

While the Court of Appeals did a thorough job of explaining the IEF and its unbroken string of annual 13th checks from 1986 to date (App 288a-291a), some additional information about how those checks are calculated will be helpful in explaining why the program is not a "bonus" and instead a program to protect retirees from the effects of inflation.

The 13th check provides inflation protection to those who need it most

The Trustees determine the total amount to be distributed in a given year in 13th checks. That number is divided by the total number of "units" (a unit is a year of service or a year of retirement) attributable to all beneficiaries to provide a dollar figure for the "unit value," *i.e.*, the value of each unit. In 2004 the unit value was $28.20 and in 2005 it was $23.36 (App 126a). In 2006 and 2007 it was $19.48 and $19.66 (App 146a). In 2008 it was $20.43 (App 162a). The 13th check for each beneficiary is then calculated by multiplying the unit value times the number of units. Thus, the longer an employee has been retired, the more units he or she will have and the larger that employee's 13th check will be. Because the fixed pensions of long-retired employees tend to be lower (their final compensation generally having been lower), and the buying power of their pension checks having been eroded over the years, the 13th check is proportionately greater for precisely those who need it most.

Brief history of the County's inflation equity program

Briefly, in the mid-1980s the County was looking for cost saving measures and sought to have its retirees forgo retiree cost of living adjustments. The Sheriffs' union was the first to collectively bargain for an agreement to forgo a COLA in exchange for the 13th check. After input from the County, the unions and the Retirement System, all parties arrived at a compromise and, effective November 1985, the County Commission enacted the inflation equity fund ordinance. Retirement Ordinance §141-32 and §141-36 (the pre-amendment IEF Ordinance, Tab B). Unlike a typical COLA plan, the IEF program did not permanently increase the base pension of retirees and their beneficiaries, thereby saving the County money.[3]

The IEF Ordinance required the Retirement System to establish a "reserve"[4] for inflation equity and to credit it annually with a portion of the earnings on defined benefit assets, but only in years when earnings exceeded a threshold percentage to be determined by the Trustees (WCCO §141-32(a), (b), Tab B). Under the IEF Ordinance, the Trustees determine what percentage of the inflation equity funds should be distributed to retirees and their survivors in an annual payment known as the "13th check" (*id.* §141-32(c)). Under the IEF Ordinance, both before and after the 2010 Ordinance, the Trustees determine the distribution formula for calculating individual checks, taking into account each retiree's period of service and length of time retired (*id.* §141-32(e), Tab B) (before) and §141-32(d) (App 338a) (after)).

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3 Yee Affidavit, System's SD Motion, Ex 3, at ¶¶14-17, App 7b; *see also id.* Ex 5, 1985 Gabriel Roeder Report to the System, explaining cost differences between COLA and IEF benefits with sample calculations, App 25b; *id.* Ex 4, July 10, 1986 Wayne County Commission meeting minutes at 713-714, App 19b-20b).

4 The Retirement System has a number of "reserve" accounts other than the IEF reserve. They include reserves for accumulated member contributions, member accounts, pension payments, defined benefit employer contributions, defined contribution employer contributions, and undistributed investment income and administrative expenses. WCCO §141-37(a)-(d), (f) (App 339a-340a). The use of reserve accounts is common to Michigan's public retirement systems. All such reserves consist solely of retirement system trust assets.

The County says that all money allocated to the IEF was "transferred" from the System's defined benefit plans (County Brief at 6). To clarify, *no* money was ever provided directly by the County to fund the IEF (Kermans Affidavit ¶39, App 33b; Yee Affidavit ¶50, App 11b; *id.*, Hutting Affidavit ¶44, App 126b). The IEF was established initially and funded thereafter with a portion of the Retirement System's investment earnings above a threshold set by the Trustees, as required by the IEF Ordinance. These were earnings from the Retirement System's common pool of investment money, including the various defined benefit reserves and the IEF reserve.

The Retirement Ordinance directs that a portion of investment earnings above a threshold to be determined by the Retirement System—generally between 8 and 10% over the years[5]—be moved to the IEF reserve for accounting purposes. Not more than once a year, the Trustees determine how much of the accumulated IEF reserve should be distributed to retirees and survivors. Recognizing that in some years no money will be added to the reserve, when investments *do* substantially exceed the threshold, not all of the money entering the reserve in that year is distributed, so that the reserve will grow and provide a cushion for years in which there are no earnings (Gabriel Roeder Report at 2, App 26b).

The circuit court was provided with summary figures for the IEF from 1985 through 2009, in chart form (App 171a-176a). In the first year, the actual return on the funding value of System assets was 13 percent, the threshold was set at 10 percent, and a portion of the earnings above the threshold ($12.18 million) were used to create the fund (App 171a). In 1986, investment returns were 11.7 percent, adding another $7.14 million to the reserve, less the distribution made that year in the first of the 13th checks (App 171a). The average 13th check in 1986 was $677.

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5 The threshold was increased to 11% in 2000 when earnings were 17.06%.

Every year thereafter, for 27 years, there has been a 13th check distributed to retirees and their survivors in late fall to assist them in coping with the effects of inflation. In most years there have been earnings above the threshold (but not for 1990 or seven recent years, 2002-2005 and 2008-2010). The average 13th check has increased over the years to a high of $2,953 in 2003. Since 2003, the IEF reserve has had an allocation only twice, in 2006 and 2007. With no money allocated in most recent years, but distributions continuing, the Trustees have distributed smaller amounts annually to manage the IEF reserve prudently. Overall from 1986 through 2009, individual distributions averaged $1,859.83 per 13th check (App 171a-176a). Due to the distribution cap in the 2010 Ordinance, in 2010 the average 13th check was only $887, by far the lowest total since the IEF program's third year and less than half the average annual check. While not in the record, there should be no dispute that the average annual 13th check in 2011 and 2012 was $698, dropping to $181 in 2013. The balance in the IEF reserve, which has had no addition since 2007, is about $3.25 million.

Assets in the IEF reserve, like the various other defined benefit reserves established in Retirement Ordinance §141-37(g) (App 340a), are combined and invested together in a common pool (Kermans' deposition at 39, App 39b). Only the defined contribution assets (contributed by employees) are invested separately from the System's general trust funds. The Retirement Ordinance specifically explains reserve accounting, which has nothing to do with the County's attempted "excess" or "surplus" labels.[6] Although the IEF reserve exists as a distinct accounting record, the assets themselves are in the Retirement System's general trust funds, with all the

6 Retirement Ordinance §141-37(g) ("Reserve Accounting") reads: "*Asset Segregation.* The descriptions of the reserve accounts shall be interpreted to refer to the accounting records of the retirement system and not to the segregation of assets by reserve account." (App 340a) In addition to the IEF, the Retirement System has about 6 other reserves (App 399a-340a), all of which hold trust assets that are the property of the Retirement System, not the County.

defined benefit funds, held for the sole benefit of the System's retirees and their survivors, and under the exclusive control of the System's Trustees (deposition of Augustus Hutting, longtime Trustee and former chair of the Retirement Commission, at 34, App 132b; Kermans Affidavit ¶¶40-41, App 33b).

In years when investment earnings do not reach the threshold, the IEF is not allocated anything. In all years, when the actuaries of Gabriel Roeder Smith and Co. calculate the County's ARC for the Trustees, the IEF reserve is not included, because inclusion would not impact the amount of the ARC. Judith Kermans of Gabriel Roeder explained this (Kermans Deposition at 51, Ex 9 to Plaintiffs' Response to Defendants' Motion for Summary Disposition Dismissing Plaintiffs' Complaint). In accounting terms, the IEF reserve is both an asset and a liability of the defined benefit plans. If the amount in the IEF reserve were added when calculating the ARC, it would also have to be subtracted because it is an equal liability. The ARC calculation would not change by even a penny. That is why the actuaries do not factor in the IEF reserve when calculating the County's ARC. The IEF program is commonly called a "gain sharing plan" (Kermans Affidavit ¶51, App 34b). Other systems refer to these programs as retiree COLAs or post-retirement adjustment programs.

From 1994 to 2000, the IEF Ordinance *required* distribution of not less than 20% or more than 50% of the IEF reserve. The Trustees proposed to the County that the limits be removed to preserve the IEF reserve and assure that annual 13th check payments would always be made, even during lean investment years (Yee Affidavit ¶¶31-32, App 9b; Hutting Affidavit ¶¶24-25, App 124b). The change in no way altered the Retirement System's dedication to providing a 13th check every year; it simply increased the likelihood that the Trustees would be able to do so.[7]

The County has always been fully apprised of the Retirement System's administration of the IEF benefit program, since the County Commission and the County Executive each have a Trustee on the Retirement Commission. Until 2010, year after year, unless absent, the County Trustees voted together with the other Trustees in favor of every motion setting the investment earnings threshold and every motion establishing the amount to be distributed annually as 13th checks.

Adoption of the 2010 Ordinance

In 2009, Matthew Schenk[8] was the County Executive's designee to serve as a Trustee on the Retirement Commission. While a Trustee, Schenk became focused on the 13th check benefit because of the underlying IEF reserve of about $44 million. At the same time, wearing his County hat, Schenk knew in 2010 of the County's difficulties in coming up with a balanced budget for approval by the end of September for the upcoming fiscal year, *i.e.*, October 1, 2010 through September 30, 2011.

The County's financial difficulties were also evident to the other Trustees. In June 2010 the County asked the Trustees to permit its actuary to calculate the ARC using an amortization period of 30 years (rather than the then-authorized 20-year period), the maximum allowed by

7 The IEF Ordinance (Tab B) also required minimum permanent pension payments to retirees whose pensions were at very low levels. There was a small one-time accounting entry to allocate funds from the IEF reserve for this purpose in 1986, but none was needed thereafter.

8 Matthew Schenk retired in 2013. He is a beneficiary of the County's 2011 retirement incentives. Although not in the record, Detroit Free Press and Detroit News accounts in July and August 2013 reported that Schenk retired at 41 with a pension exceeding $96,000 annually after 8 ½ years of employment with the County.

PERSIA.[9] Earlier the County had requested a lengthier "smoothing period" for the actuarial calculations, another change that provided the County with ARC relief (Hutting Affidavit ¶18, App 123b). The Trustees accommodated the County's requests, to the extent permitted by their fiduciary obligations and PERSIA.

The County, which had been making regular installment payments of its ARC as often as every two weeks, started holding onto the ARC funds for longer. Payments became quarterly by mid-2008 and, in fiscal year 2010-2011, after the 2010 Ordinance, only one annual payment was made at year end. Postponing payment to fiscal year end (the last date permitted) increases the amount of the ARC because the original actuary calculations are based upon assumptions of periodic payments throughout the year.

In 2002 and 2003, the Retirement System was overfunded (106% and 103% respectively). Since 2003, the System's funding level has gone down every year (App 124a, *Funding Progress Indicators* chart, column 4, under "Total," 2001-2009). The reduction is partially due to reduced investment earnings, particularly in 2008 and 2009. But benefit changes that have been implemented since 2003 and the County's generous early retirement incentives have substantial costs associated with them that have further depressed the funding level.

In August of each year the Retirement System's actuary determines the County's contribution rate for the next fiscal year. The ARC is determined by applying the contribution rate to the County's payroll.[10] On August 24, 2010, the County sent a letter to its employees,

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9 A longer amortization period provides the County with more time to fund its obligations, thereby reducing the amount of the ARC each year (Hutting Affidavit ¶18, App 123b). The change in June 2010 reduced the County's ARC by approximately $5 million.

10 To illustrate with non-record but undisputed public figures, the County's contribution rate increased from 30.26% for the fiscal year commencing October 1, 2010 (resulting in an ARC of about $36.3 million) to 39.68% for the fiscal year commencing October 1, 2012

describing a County proposal to "temporarily suspend" what the letter termed "the so-called 'thirteenth (13th) bonus check'" until the Retirement System "returns to fully funded status" (Hutting Affidavit ¶15, App 123b , and attached letters (128b-131b); especially the third one, an August 24, 2010 letter, App 131b). This proposal had been rejected by the County Commission earlier in August, according to the letter. The County letter warned that not suspending the so-called "bonus" 13th check would likely result in 400-500 additional layoffs five weeks hence, endangering the employment of County workers with less than 15 years seniority (*id.*).

A few days after this letter, Hutting responded to it in a writing addressed to all County employees and retirees (Hutting Affidavit ¶15, 2nd attached letter, App 129b). Hutting warned that the threatened layoffs were a ruse, as was the alleged impact of the 13th check distribution on the County's ARC for the year (App 130b). He explained that the 13th check was a COLA substitute, not a bonus (App 129b). He predicted that the County's real intent was to use the System's IEF reserve to "pay" the majority of its 2010 ARC.

On September 30, 2010, the deadline for adoption of a budget, the newly amended IEF Ordinance (the "2010 Ordinance") became effective and the County presented a 2010-2011 budget that allocated to the Retirement System only a fraction of the amount required to pay its ARC that year. Between that year and the next, the County underpaid its ARC by about $32 million, relying on the transfer from the IEF reserve and offset mandated by the 2010 Ordinance.

The immediate and long-term effects of the 2010 Ordinance

(i) Effect of the 2010 Ordinance on the IEF Ordinance

The circuit court had before it an "IEF Ordinance Comparison Chart" (App 133b), comparing the provisions of the IEF Ordinance, WCCO §§141-32 and 141-36, before the 2010

(resulting in an ARC of over $47.8 million). An early retirement incentive offered by the County in April 2011 caused much of this increase.

Ordinance (*id.* left column) with the provisions in the amending Enrolled Ordinance 2010-514 (*id.* middle column). To see the text of WCCO §141-32, before and after the amendment, *compare* the IEF Ordinance (Tab B) *with* the 2010 Ordinance (App 226a-228a.)

In the WCCO §141-32 amendments, the 2010 Ordinance imposed a cap of $12 million on the IEF reserve, where before no cap had existed. The 2010 Ordinance provided that every dollar above the new cap, totaling about $32 million, could be used by the County to offset its ARC payment (App 226a, subsection (b)(3)). In that fiscal year and the next, the County used more than $32 million of Retirement System trust assets to reduce its ARC. In an inconsistency that speaks volumes, the 2010 Ordinance contains both a $12 million cap and a promise to consider *reimbursing* the IEF for the $32 million underpayment of the County's minimum funding obligation:

> (f) Within 9 months of first annual distribution from this fund, the [County] CFO shall explore and report to the Wayne County Commission whether it is advantageous to issue bonds as a strategy to fully fund the retirement system ***and reimburse the Inflation Equity fund of $32 million dollars.*** (App 227a, subsection (f); emphasis added.)

There has been no "reimbursement."

In the WCCO §141-36 amendments, the 2010 Ordinance dictates to the System's actuaries that a 35-year amortization schedule must be used to determine the ARC, contrary to PERSIA. PERSIA, specifically MCL 38.1140m, requires that amortization periods not exceed 30 years. A 35-year period also does not comply with the reporting standards of the Governmental Accounting Standards Board (Kerman Affidavit ¶44, App 34b).[11] The effect of a longer

[11] Carla Sledge, former County Chief Financial Officer, who together with Schenk proposed the 2010 Ordinance, testified that she was aware of the 30-year limit under PERSIA but *unaware* that the 2010 Ordinance provided for a 35-year amortization period (Retirement System Summary Disposition Motion, Ex 19, Sledge deposition at 100). For his part, Schenk testified that he did not know what the maximum lawful period was (*id.*, Ex 20, Schenk deposition at 205).

amortization period is to extend the County's time to pay its obligation and thereby lower the ARC each year. Also, as adopted, the WCCO §141-36 amendment requires the Retirement System's actuary to utilize data for employee compensation from the early 1980s that is no longer maintained or available (Kerman Affidavit ¶45, App 34b).

(ii) The County avoids paying $32 million of its minimum funding obligation

On the deadline of September 30, 2010, the County Commission enacted the 2010 Ordinance by a vote of 8 to 7, and then immediately adopted the County's Budget, which had been initially presented on June 24, 2010 (and which proposed using IEF trust funds to pay the ARC), as a "balanced budget." But for the 2010 Ordinance, the County's budget would have been out of balance by millions and noncompliant with the Uniform Budgeting and Accounting Act, MCL 141.421.

(iii) The financial benefits of retirees and beneficiaries are diminished

From the perspective of the Retirement System's members, retirees and their survivors, the 13th checks approved on October 1, 2010 were less than half what they otherwise would have been and, on average, less than 13th checks had been since 1988. The same was true in 2011 and 2012. The IEF reserve would now be exhausted, except that the Trustees held back a portion in case the County prevailed on its counterclaim, which requested that the Retirement System pay its attorney fees from the IEF reserve. Even without that now-abandoned threat, the reserve remains on the brink of exhaustion because the County has chosen not to comply with any portion of the Court of Appeals' ruling during this appeal. There has been no reimbursement.

At this writing, the IEF reserve balance is about $3.25 million. The $12 million balance after enactment of the 2010 Ordinance has been reduced by three annual 13th check distributions, the last only about $180 on average per 13th check. No investment earnings have been added to the reserve. Preliminary steps have been taken to determine the distribution amount for the fall of 2014, which will reduce the IEF reserve balance further.

Procedural history

The Retirement System filed a verified complaint for mandamus, declaratory judgment and injunctive relief on November 8, 2010, and sought a temporary restraining order, show cause and preliminary injunction. A temporary restraining order was entered but, after four days of hearings, it was lifted. The County responded with an answer and affirmative defenses. In December 2010 the County's then-counsel (Clark Hill) sought leave to withdraw. The parties stipulated to the withdrawal and the court stayed proceedings to afford the County time to obtain new counsel and to permit the System to file an amended and restated verified complaint (the "Amended Complaint," App 2a-22a).

The County answered the Amended Complaint in late January 2011 and at the same time filed a counter-complaint, which the Retirement System answered in February (App 23a-61a). Count III of the counterclaim asserted that the Retirement Commission had breached its fiduciary duties in various respects outlined by the circuit court in its opinion dismissing that claim (App 150b-154b) and in the portion of the Court of Appeals opinion that discusses the cross-appeal (App 310a-317a).

Cross motions for summary disposition were filed in August 2011 and heard the next month. On September 29, the circuit court denied the Retirement System's motion and granted the County's motion as to the System's Amended Complaint (App 274a-277a). The circuit court rejected the System's constitutional argument and then briefly addressed one aspect (only) of the System's PERSIA argument, ruling that the 2010 Ordinance did not violate MCL 38.1140m (App 277a). The circuit court dismissed the System's claims for "exclusive benefit" and "prohibited transaction" violations under MCL 38.1133(6) without discussing them, for the reasons argued by the County (*id.*). Reconsideration was denied on November 28, 2011.

On December 20, 2011 the circuit court held that the Retirement System's Trustees had not breached their fiduciary duties or otherwise acted unlawfully, and dismissed Count III of the County's counterclaim (App 150b-App154b). After the parties' competing reconsideration motions were denied, the System timely appealed the September 29, 2011 decision and the County cross-appealed the dismissal of its Count III. The Court of Appeals reversed in substantial part the dismissal of the System's claims (App 278a-310a), as discussed in this brief, and affirmed the dismissal of the County's claims (App 310a-317a). In this Court, the County has dropped its counterclaim completely and has not appealed the ruling that the 2010 Ordinance's amortization provision is invalid (App 309a-310a) or the ruling that whether to grant an offset during a time of surplus is a decision for the Trustees, not the County (App 306a).

The County states frequently in its statement of facts to this Court that the Retirement System's PERSIA argument in both the circuit court and the Court of Appeals was focused on a violation of MCL 38.1140m (County Brief at 10, 12, 13, 14, 15). This is incomplete. The System's PERSIA argument always has been based on MCL 38.1133(6) as well as 38.1140m. The latter provision establishes the amortization period violation, the primacy of the Trustees and their actuary in determining the ARC, the requirement that the County pay its ARC annually, and the proposition that only the Trustees, not the County, can decide to move assets from the IEF reserve or permit an offset. MCL 38.1133(6) establishes the exclusive benefit and prohibited transaction violations. As the Retirement System has explained in previous briefs, the question is not whether MCL 38.1140m directly *prohibits* the offset but whether the exception it carves out *permits* the offset. The transfer already was presumptively prohibited by the exclusive benefit and prohibited transaction rules, MCL 38.1133(6). Although the circuit court chose to focus on MCL 38.1140m in its opinion, the Retirement System always has argued on the basis of all the County's PERSIA violations.

The County sought leave to appeal to this Court, raising PERSIA issues, and the Retirement System responded as to those issues. In November 2013, this Court scheduled the matter for oral argument and requested supplemental briefing on the Pension Clause as well as PERSIA issues (App 155b). The parties exchanged briefs and argument was held in March 2014. On April 1, 2014, this Court granted leave to appeal and requested that the parties' briefs discuss:

- The source and nature of the County's power to move funds from the IEF;
- Whether this movement of funds would violate PERSIA if the ARC had been paid; and
- Whether the movement of IEF assets to the defined benefit plan was a "transaction" under PERSIA (App 319a).

ARGUMENT

I. THE COUNTY HAS NO POWER TO MOVE FUNDS FROM THE IEF

A. The standard of review is de novo

The Retirement System agrees with the County (County Brief 19) that the standard of review is de novo. "[R]ulings on motions for summary disposition, issues of statutory construction, matters concerning the interpretation and application of municipal ordinances, and questions of constitutional law" are all reviewed de novo (App 294a, citing *Midland Cogeneration Venture Ltd P'shp v Naftaly*, 489 Mich 83, 89 (2011), *Spiek v Dep't of Transp*, 456 Mich 331, 338 (1998)). *See also Board of Trs of the Policemen & Firemen Ret Sys v City of Detroit*, 270 Mich App 74, 77, *lv den* 477 Mich 892 (2006) (*City of Detroit-2006*).

B. This Court did not ask about the County's general power to make forward-looking, prospective amendments to the Retirement Ordinance; it asked about the County's power to move existing IEF trust assets. All such power resides with the Trustees of the Retirement System

The County has answered a question different from the one this Court asked. It stresses that the Charter Counties Act requires that when counties like Wayne, which already had a retirement system, adopt a charter, that charter "shall not preclude future modification of the system" (County Brief 21, quoting MCL 45.514(1)(e)). And, indeed, the County's Charter provides that the County Commission "may amend the [Retirement] ordinance." Wayne County Charter §6.111, App 327a). But there is no dispute about the County Commission's general power to amend the Retirement Ordinance.[12]

The decision being reviewed by this Court carefully upheld every portion of the 2010 Ordinance that did not violate PERSIA:

> We hold that plaintiffs established, as a matter of law, violations of PERSIA's exclusive-benefit rule embodied in MCL 38.1133(6), PERSIA's prohibited-transaction rule found in MCL 38.1133(6)(c), and, under MCL 38.1140m, PERSIA's directive giving the Retirement Commission sole authority, through an actuary, to devise and calculate the ARC formula. On the basis of these PERSIA violations, we invalidate and strike down those provisions in the 2010 ordinance, as codified in WCCO, §§141-32 and 141-36, regarding the transfer or reallocation of IEF assets, the offset, the amortization caps and ARC formula, the potential

[12] The County's power to amend the Retirement Ordinance prospectively, of course, is not completely unchecked. Even forward-looking amendments are restricted by the Pension Clause, Const 1963, art 9, §24, and by PERSIA, as the County admits. The County's power is also restricted by Michigan's Public Employment Relations Act (PERA), which makes it unlawful for a public sector employer to fail to bargain collectively in good faith with a labor organization over mandatory subjects of bargaining. MCL 425.215(1). Retirement and pension benefits are mandatory subjects of collective bargaining. Changes in the IEF benefit undoubtedly are of vital interest to active employees, even though they do not yet receive the benefit. The County enacted the 2010 Ordinance without bargaining, changing the IEF benefit unilaterally. This issue is being litigated now, as to this very ordinance, and the matter currently is before the Michigan Employment Relations Commission, following a 2013 decision and recommended order from an Administrative Law Judge that was adverse to the County. *Wayne County v Michigan AFSCME Council 25, AFL-CIO*, Case No C10 J-266, Docket 10-000060-MERC.

> reimbursement of the $32 million IEF excess, and the County's control over an offset decision relative to true defined benefit plan surpluses. (App 317a)

The balance of the 2010 Ordinance was upheld. The County has not appealed to this Court from the Court of Appeals' decision with regard to the amortization caps and ARC formula or the ruling that the Trustees—not the County—control the offset decision when there is a plan surplus. The County acknowledges that its power to amend is subject to "constitutional" and "statutory" limitations (County Brief 20). Its decision not to appeal the striking down of these ordinance provisions is acknowledgment by deed as well as word. The County appeals only the "money" decision, *i.e.*, only the ruling that it owes the Retirement System $32 million in ARC that it did not pay, because its attempt to make that payment with IEF assets failed.

But it is the "money" decision this Court asked about when it requested "an identification of the source and nature of the County's power to move funds from the Inflation Equity Fund (IEF)" (App 319a). Charter §6.111 permits the County to amend the Retirement Ordinance, but it contains no authority to make use of assets already in the Retirement System. As to that, the very next section of the County Charter provides that "[t]he Retirement Commission shall administer and manage the Retirement System." Charter §6.112 (Tab A). The IEF reserve—the trust assets themselves—are to be administered and managed by the Trustees, not the County.

This aspect of the Wayne County Charter (§6.112) reflects the governing state law, PERSIA. PERSIA establishes controlling law with respect to the investment, use and disposition of Retirement System assets, as well as the calculation of the ARC, the sum the County must pay each year under the annual funding requirement of the Pension Clause. There is no dispute between the Retirement System and the County whether PERSIA controls here. The parties agree that it does. The provisions of PERSIA "supersede any investment authority previously granted to a system under any other law of this state." MCL 38.1133(1). PERSIA supersedes all local ordinances *and any other* investment authority under Michigan law. *Board of Trustees v Detroit,* 143 Mich App 651, 656 (1985), *lv den* 424 Mich 875 (1986) (*City of Detroit-1985*).

PERSIA controls the investment, use and disposition of all Retirement System assets. Those assets include "the total of the cash and investments of a system valued at market." MCL 38.1132a. PERSIA also dictates that all these assets be held in trust for the exclusive benefit of System participants and their beneficiaries. Section 13 states: "The system shall be a separate and distinct trust fund and the assets of the system shall be for the exclusive benefit of the participants and their beneficiaries and for defraying reasonable expenses of investing the assets of the system." MCL 38.1133(6). In other words, all the Retirement System's cash and investments are required by PERSIA to be held in trust for two limited uses: (1) the exclusive benefit of the participants and their beneficiaries and (2) defraying the reasonable expenses of investing the assets of the system. MCL 38.1133(6); *City of Detroit-1985*, 143 Mich App at 654 ("We feel that the language of this statute is unambiguous on its face").

The County has no role to play with regard to the administration, management, or disposition of trust assets within the Retirement System's control. No such authority is provided in the Michigan Constitution, PERSIA, the Charter Counties Act, or the Wayne County Charter.

1. The Constitution does not give the County the power to move retirement trust assets

The Michigan Constitution, the County points out, permits it to adopt a county charter and to adopt ordinances relating to its concerns (County Brief 20, citing Const 1963, art 7, §2). But of course the power to adopt an ordinance does not entail the power to move assets held in trust by a retirement system. Moreover, as the Retirement System explains below in subsection (C), the Constitution requires the County to pay its ARC each year. Const 1963, art 9, §24, 2^{nd} ¶.

2. The Charter Counties Act does not give the County the power to move retirement trust assets

Similarly, the Charter Counties Act provision that bars a County from enacting a county charter that precludes future modification of the County's retirement system, MCL 45.514(1)(e) (County Brief 21), is not a grant of power to move the System's trust assets from one place to another.

3. The County Charter does not give the County the power to move retirement trust assets and affirmatively vests administration and management in the Trustees

Nor does Wayne County Charter §1.112, which gives the County "home rule" power (County Brief 21 n.16, citing §1.112, 325a-326a), permit it to interfere with the System's management of its trust assets. Note the "Compiler's comments" concerning the limits of "home rule" power:

> An attempt to exercise home rule powers is overridden, however, by state laws which address matters of state-wide, as opposed to merely local, concern. This limitation was cited by Third Circuit Judge Roland Olzark in Civil Action No. 84-401649 CK, *Donald Gray vs. Wayne County Retirement System, et al*, on August 31, 1984. In that case, a county ordinance was held invalid because it provided for "20 and out" retirement benefits, in contravention of a state law (MCL 46.12a) which required 25 years of service or reaching age 55 or 60 for retirement eligibility (326a).

The County appealed Judge Olzark's decision to the Court of Appeals, which affirmed despite several County arguments that "home rule charter counties" need not conform to general state statutes, that Wayne County's reorganized governmental structure "rendered nugatory" the conflicting state statute, and that Wayne County had "opted out" from the statutory requirement. *Gray v Wayne County*, 148 Mich App 247, 252 (1986). The County does not seek to revive any of these discredited arguments here, and concedes (as it must) that PERSIA overrides any powers it may have by virtue of being a "home rule" county. *See Grand Haven v Dairy Co*, 330 Mich 694 (1951). Indeed, the Wayne County Charter itself provides that "[t]he Retirement

Commission shall administer and manage the Retirement System" (§6.112, Tab A).

> [A] county's authority, like the authority of townships, cities, and villages, is derived from and limited by the constitution and valid state statutes.... Our Supreme Court "has repeatedly stated, local governments have no inherent powers and possess only those limited powers which are expressly conferred upon them by the state constitution or state statutes or which are necessarily implied therefrom."

Michigan Municipal Liability and Property Pool v Muskegon Cty Bd, 235 Mich App 183, 190 (1999).

4. PERSIA does not give the County the power to move retirement trust assets and affirmatively vests administration and management of trust assets in the plan's Trustees

PERSIA completely negates any possibility that the plan sponsor—the governmental employer whose employees and retirees are the beneficiaries of the plan's assets—can move trust assets already under the control of the independent entity whose legal and fiduciary duty it is to make administrative and managerial decisions about those assets. PERSIA is the statute that prescribes "the powers and duties" of the System's Trustees, as the preamble states. It supersedes any authority previously granted to any system by any other law of the state (MCL 38.1133(1)).

Under PERSIA, it is the Trustees, not the County, who are responsible for the general administration, management, and operation of the retirement system. *City of Detroit-2006*, 270 Mich App at 77. "The system shall be a separate and distinct trust fund" under PERSIA, MCL 38.1133(6). A retirement system is a "public body." *Detroit News, Inc v Police & Fire Retirement System of the City of Detroit*, 252 Mich App 59, 71 (2002) (for FOIA purposes).

PERSIA explicitly provides the Trustees of a retirement system, not the governmental employer, with the discretion to permit an offset of trust assets. A case that illustrates this well is *Retired Detroit Police & Fire Fighters Ass'n v Detroit Police Officers Ass'n*, 2010 Mich App LEXIS 2414, 2010 WL 5129841 (Mich App 2010), *lv den* 489 Mich 934 (2011) ("*Detroit Police Officers Ass'n*") (Tab D). An association of retired Detroit police and fire fighters sued several unions and the City of Detroit, trying to reverse a decision by that system's trustees to allow the City a $2.5 million credit against its ARC during a period when the system was overfunded. The unions were sued by the retirees because active police and fire employees stood to receive benefit enhancements because of the credit. The retirement system, its trustees accused of violating their fiduciary duties, intervened. The circuit court ultimately dismissed the case for lack of standing, because the retirees had not been denied any benefit or suffered any injury. On appeal, the Court of Appeals affirmed, stressing the retirement system's separate, independent existence and the discretion vested in its trustees—and no one else—to permit an offset under MCL 38.1140m during a period of overfunding. 2010 LEXIS 2414, *9 (Tab D). The County's reliance on MCL 38.1140m as an example of a permitted offset overlooks that *only* the Trustees have discretion to allow an offset.

In 2002, PERSIA was amended to add additional protections to the systems' participants and their beneficiaries by expressly precluding the involvement of parties in interest like the County in intra-system financial decision-making. MCL 38.1140m. *See Board of Tr of the Policemen/ Firemen Ret Sys v City of Detroit*, 2005 Mich App LEXIS 1387 (Mich App 2005), *lv den* 474 Mich 1068 (2005) ("*City of Detroit-2005*") (Tab E); *City of Detroit-2006*, 270 Mich App at 77; *Detroit Police Officers Ass'n* (Mich App 2010) (Tab D).

The Trustees are accorded broad governance powers as the investment fiduciary, limited only by PERSIA itself. *City of Detroit-2006,* 270 Mich App at 84-85. Section 13 provides that the "assets of a system may be invested, reinvested, held in nominee form, and managed by an investment fiduciary" subject to PERSIA's other provisions. MCL 38.1133(1); *City of Detroit-1985,* 143 Mich App at 654 ("This language is not ambiguous because it grants the investment fiduciary broad powers."). The Trustees are "vested with the general administration, management, and operation" of the system, as well as for "implementation and supervision" of the system. MCL 38.1140m; *City of Detroit-2006,* 270 Mich App at 75. "Part of the [trustees'] responsibilities is to ensure that the retirement system is properly funded." *Id.* The Trustees also are responsible for establishing, with the actuary, the ARC, as well as insuring that the ARC is paid. *City of Detroit-2006,* 270 Mich App at 81-85.

5. In contrast to public pensions regulated by PERSIA, where the Plan's Trustees administer and manage the trust assets, ERISA regulates private pensions in a different way

All pension systems are regulated with the goal of optimizing the probability that pension promises will be kept—that they will be adequately funded and that the funds needed to keep the plan's promises in the future will be adequately protected. More than one approach may be used to achieve these goals. In Michigan, a cornerstone of the regulatory scheme is that plan sponsors—the governmental employers—do not administer or manage plan assets. That task is given to a separate legal entity, controlled by Trustees whose job it is to administer and manage the assets. PERSIA is the statute that establishes this framework.

In contrast, pensions in the private sector are governed by ERISA and Department of Labor regulations. An ERISA plan administrator may be a separate entity, but most often is the plan sponsor. ERISA §3.16(B), 28 USC 1002(16)(b). The employer (plan sponsor) is a "party in interest" with respect to both public, MCL 38.1132d(4)(c), and private pension systems. ERISA, like PERSIA, bans "prohibited transactions" and has an "exclusive benefit" rule, but enforcement mechanisms differ. The Department of Labor can assess a civil penalty that is 20 percent of the amount recovered in connection with a breach of fiduciary duty. In addition, under the Internal Revenue Code, a tax equal to 15 percent of the amount involved in a prohibited transaction may be assessed annually against persons who participate in the transaction. 26 USC §4975(a). Under PERSIA, it is the Trustees who decide whether to permit an offset when there is surplus funding. MCL 38.1140m. *Detroit Police Officers Ass'n.* Under ERISA, if the plan is overfunded, "the employer may reduce or suspend his contributions." *Hughes Aircraft v Jacobson*, 525 US 432, 440 (1999) (discussed in §II(D)(2), *infra*).

In the present case, the Court of Appeals correctly noted that ERISA cases are not binding in this PERSIA-controlled dispute (App 300a-301a), even when they are analogous. In the context of this Court's first question—the source of power to move trust assets—there is no true analogy in terms of what a private plan sponsor, who may also be the plan administrator, may be permitted to do under ERISA.

Because all of the Retirement System's assets are held in trust under PERSIA for the exclusive benefit of participants and their beneficiaries (and certain prescribed expenses), the trust fund must be administered by investment fiduciaries. An "investment fiduciary" is defined to mean a person (other than a participant directing the investment of the assets of his or her individual account, *i.e.*, a person with a defined contribution account) who exercises discretionary authority or control in the investment of system assets. MCL 38.1132c. The Retirement Commission is the "investment fiduciary" for the Retirement System under PERSIA. *City of Detroit-1985*, 143 Mich App at 654.

The "exclusive benefit" rule is a manifestation of the duty of loyalty that underlies trust law. The "prohibited transaction" rule is a specific application of this general duty, barring self-dealing, dealings with parties in interest, and other conflicts of interest. Although the concepts are common to both PERSIA and ERISA, the manner in which they are enforced is quite different. Under PERSIA, it is up to the Trustees (rather than the Department of Labor or Internal Revenue Service) "to ensure that the system is properly funded," *City of Detroit-2006*, 270 Mich App at 75, and to take action against abuses, which they have done in this case.

C. The 2010 Ordinance violates the Pension Clause, Const 1963, art 9, §24

As part of its first argument, the County has chosen to address a question that this Court did not ask and that the County's application for leave to appeal did not state as an issue—whether the 2010 Ordinance violates the first paragraph of the Pension Clause, the "nonimpairment" provision (County Brief 23-30). The County is sparring with its own shadow here, however, because the Court of Appeals did not rule on the basis of any such violation. The Court of Appeals based its decision solely on PERSIA violations:

- We find it unnecessary, for the most part, to analyze this case under Const 1963, art 9, §24 (App 284a);
- [T]here exists a general presumption by this Court that we will not reach constitutional issues that are not necessary to resolve a case.... Because the offset issue can be resolved under PERSIA, we ultimately decline to rule on whether it violates Const 1963, art 9, §24" (App 299a n.23; citations omitted)

1. The nonimpairment clause

The County's constitutional argument focuses exclusively on the first of the two paragraphs that make up Const 1963, art 9, §24, ignoring the equally important second paragraph. The Retirement System has argued in the lower courts that both paragraphs—the "nonimpairment" provision *and* the "annual funding" provision—are violated by the 2010 Ordinance. Because the Court of Appeals ruled only on PERSIA grounds and the County sought leave to appeal only on those PERSIA grounds, the Retirement System likewise has focused in this Court on the statutory rather than constitutional issues.[13]

There are important constitutional and PERA issues at stake, as between the County and its employees, active and retired, with respect to the 2010 Ordinance, which sought to gut a

[13] The Retirement System did address Const 1963, art 9, §24 in its supplemental brief in this Court, because the Court specifically asked the parties to do so (App 155b). No such request was included in the order granting leave to appeal (App 319a).

longstanding, collectively-bargained-for financial benefit designed to ameliorate the adverse effects of inflation on a fixed pension. These are addressed in the amicus briefs that the Michigan Association of Public Employee Retirement Systems and the National Conference of Public Employee Retirement Systems will seek permission to file in this case.[14]

This Court, like the Court of Appeals, should prefer a decision that resolves this case under PERSIA and leaves for another day the Pension Clause issues. Because the County has chosen to address half of the Pension Clause issue, however, the Retirement System will respond in part. Because of space restrictions, as to the first portion of the Pension Clause, the "nonimpairment" clause, the Retirement System will rely on the arguments in the amicus briefs of NCPERS and MAPERS, which the Trustees ask that this Court permit to be filed.

2. The annual funding clause

As to the second portion of the Pension Clause, there is a blatant violation of the "annual funding" requirement:

> Financial benefits arising on account of service rendered in each fiscal year shall be funded during that year and such funding shall not be used for financing unfunded accrued liabilities. Const 1963, art 9, §24, second paragraph.

This requirement is echoed in PERSIA, MCL 38.1140m, and in the Wayne County Charter, §6.113. The Court of Appeals explained the purpose of the annual funding clause, albeit without deciding whether the 2010 Ordinance violated it:

> "T]he purpose of the provision was to prevent the shifting of the burden for pensions from the taxpayers who derived benefit from the services rendered to future taxpayers by 'back door' spending, *i.e.*, by diverting current funding to finance unfunded accrued liability." *Jurva v Attorney General*, 419 Mich 209, 224-225; 351 NW2d 813 (1984). The establishment and maintenance of the actuarial soundness of pension systems was the delegates' overriding concern at the Constitutional Convention. *Id.* at 225. (App 291a; footnote omitted)

14 MAPERS filed an amicus brief in the Court of Appeals, supporting the position of the Retirement System.

Neither lower court addressed the County's violation of the annual funding clause, although the Retirement System raised the issue in both courts. Instead of paying $32 million of the actuarially-calculated ARC—the County's constitutionally-mandated pension funding obligation—the County simply passed an ordinance. The Retirement System raised the issue in the circuit court, but it was not addressed there.

The County is contractually obligated to fund all financial benefits arising on account of service rendered during a year, as determined by the Retirement System's actuaries, *in that year*. The County's ARC for the 2010 fiscal year was about $36.3 million, but the County paid only about $10 million. The Retirement System was shortchanged more than $26 million. The ARC for the next fiscal year was about $48 million or about $23.6 million for the first six months of the fiscal year. Instead of paying that amount, the County paid only about $17 million in April 2012, claiming that they still had a $6 million credit because they only used $26 million of the $32 million "offset" they took from the IEF reserve the year before.

The County, of course, claims that it *did* pay its full ARC by moving $32 million already held by the System in trust for the benefit of member retirees and their survivors. The County, by fiat in the 2010 Ordinance, treated this $32 million as "excess" funds being used for "bonus" checks and, therefore, somehow, as money that the County, and not the Trustees, was entitled to use as it wished. But this was money held in trust by the Trustees. It was not the County's money. It was not surplus. The County could make *no* decisions with respect to these trust funds. The Retirement System was shortchanged by the County and has $32 million *less* to invest and grow than it should have. The Retirement System is in the business of investing its assets for the benefit of plan participants and the County's underpayment has cost the System far more than $32 million because of the market's strong performance since 2010.

The 2010 Ordinance also promised to "explore" ways of "reimbursing" the $32 million to the System. This is exactly what the annual funding clause was written to forbid:

> The paramount concern of the 1961 Constitutional Convention, as it debated the precise language of this section, was to ensure the proper maintenance and the actuarial integrity of the state pension system.

Shelby Twp Police & Fire Ret Bd v Shelby, 438 Mich 247, 253 (1991). This Court's footnote to the quoted sentence could have been written for the County in this case:

> [This] section is an attempt to rectify, in part, policies which have permitted sizeable deficiencies to pile up in retirement systems in this state. Under this section, accruing liability in each fiscal year must be funded during that year, thus keeping any of these systems from getting farther behind than they are now. [2 Official Record, Constitutional Convention 1961, p 3402].

In *Shelby Township*, the township was paying the retirement board less than the annually "certified" amount determined by the board's actuary. Because of this shortfall, the board's actuaries determined that the pension fund was underfunded. This Court had to determine, among other matters, whether the Pension Clause mandates that the ARC must include current service costs as well as unfunded accrued liabilities. The Court held it does:

> Our assessment of Art. 9, §24 and our examination of the constitutional debates, reveals the framers' clear intent to create a contractual obligation to ensure the full payment of financial benefits in the pension and retirement system. Permitting the township to fund only pensions payable in that year to current retirees and beneficiaries would unjustly alleviate the township of its obligation to fully fund the pension system.
>
> We therefore find that the second paragraph of Art. 9, §24 expressly mandates townships and municipalities to fund all public employee pension systems to a level which includes unfunded accrued liabilities.[15] *Shelby Township*, 438 Mich at 255.

A purpose of the annual funding clause certainly was to prevent violations of the nonimpairment clause, *i.e.*, to prevent the diminishment or impairment of accrued financial benefits. *Id.* at 254,

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15 "'Unfunded accrued liabilities' are the estimated amounts which will be needed according to actuarial projections to fulfill presently existing pension obligations..." *Shelby Township*, 438 Mich at 256 n.4, *citing Kosa v Treas'r, State of Mich*, 408 Mich 356, 364 n.11 (1980).

citing *Advisory Opinion re Constitutionality of 1972 PA 258*, 389 Mich 659, 663 (1973). Any failure to pay the full ARC threatens to diminish and impair accrued financial benefits. But these are separate, distinct violations. The County may not violate the annual funding clause, whether or not there is a concurrent violation of the nonimpairment clause. The County's failure to pay its ARC violated not just the Pension Clause, but also PERSIA (MCL 38.1140m) and the Wayne County Charter (§6.113).

Shelby Township's practice of underfunding the pension system was coined a "borrowing scheme" by this Court. Plainly, the 2010 Ordinance also is a borrowing scheme, trying to plug a hole in the County's budget that has been many years in the making. The County admits that it enacted the 2010 Ordinance to balance its budget and avoid layoffs and curtailment of County services (App 298a n.20, referencing 8/24/2010 County letter to employees). The 2010 Ordinance itself acknowledges that $32 million was "borrowed" from the IEF reserve as an alternative to issuing bonds:

> (f) Within 9 months of first annual distribution from this fund, the CFO shall explore and report to the Wayne County Commission whether it is advantageous to issue bonds as a strategy to fully fund the retirement system and ***reimburse*** the Inflation Equity fund of $32 million dollars. (App 338a, §141-32(f); emphasis added)

As a borrowing scheme (without collateral or interest), the 2010 Ordinance's "promise" is even more illusory than the promise of future benefits (unless they were canceled) made in 2010 legislation that mandated withholding of 3% of teachers' wages to be applied towards employer contributions to the Michigan Public School Employees Retirement System (MPSERS). The Court of Appeals struck down that statute in *AFT Michigan v State of Michigan*, 297 Mich App 597 (2012), in part under the Contract Clause, as a forced loan to the employer school districts, with no right to receive anything in return and no guarantee of repayment. 297 Mich App at

625.[16] Of course, as discussed later in this brief, under PERSIA, a "loan" without adequate security and a reasonable rate of interest is prohibited. MCL 38.1133(6)(b).

II. MOVING IEF ASSETS WITHOUT THE TRUSTEES' CONSENT, WHETHER THE ARC IS PAID OR NOT, VIOLATES PERSIA

A. The standard of review is de novo

This too is a question of law, reviewed de novo by this Court. *See Naftaly*, 489 Mich at 89; *Spiek*, 456 Mich at 338; *City of Detroit—2006*, 270 Mich App at 77; the Court of Appeals opinion in the present case (App 294a), and the County's brief (County Brief 19).

B. Even if the ARC had been paid, PERSIA was violated because only the Trustees could decide whether IEF assets should be moved

In addressing whether it violated PERSIA by directing the movement of IEF assets, the County structures its argument in two main sections, namely whether the movement of IEF assets violates the "exclusive benefit" rule (County Brief 32-44) and whether it violates the "prohibited transaction" rule (County Brief 44-49). The latter section is the County's response to the third question posed by this Court in its order granting leave to appeal. The Retirement System will address both of these issues as well, and in the same order, but it begins by pointing out that the County violated PERSIA in additional ways when it directed the movement of trust assets out of the IEF reserve.

As the Retirement System showed in answering this Court's first question, governance over the System's trust assets—including all assets in the IEF reserve—resides exclusively with the Trustees, not the County. While this is a requirement of the Wayne County Charter, §6.112

16 Replacement legislation was then enacted, eliminating the mandatory nature of the withholding and making it prospective-only. After another lawsuit was filed, the Court of Appeals affirmed the new legislation against a variety of challenges. *AFT Michigan v State of Michigan*, 303 Mich App 651, *lv gtd* 495 Mich 1002 (2014). This Court granted plaintiffs' application for leave to appeal in the second case on May 21, 2014.

("The Retirement Commission shall administer and manage the Retirement System") (Tab A), it is first and foremost a requirement of PERSIA, *see supra* at 22-24. The Retirement System is "a separate and distinct trust fund," MCL 38.1133(6), and the Trustees are vested with the general administration, management, and operation of the System, MCL 38.1140m. Michigan case law uniformly supports this conclusion. *City of Detroit-2006*, 270 Mich App at 75; *Detroit Police Officers Ass'n*, 2010 LEXIS 2414, *9 (Tab D). Accordingly, the 2010 Ordinance violates PERSIA without regard to whether the County did or did not pay its full ARC. Moreover, there is an actuarial side effect of moving IEF assets. If $32 million in IEF assets is moved into the defined benefit pool used to calculate the ARC, the ARC would be reduced. Although this calculation is not in the record here, the County concedes that there would be a reduction (County Brief 33). The Retirement System's actuaries originally estimated that the reduction would be about $1.8 million, thus benefiting the County, a party in interest. MCL 38.1132d(4)(c). Accordingly, as the Court of Appeals held (App 306a n.29), the movement of IEF assets alone results in a PERSIA violation.

C. The 2010 Ordinance violates the "exclusive benefit" rule

The Court of Appeals held that §141-32(b)(3) (App 338a) of the 2010 Ordinance, the provision directing the use of $32 million in the IEF reserve to reduce the County's minimum funding obligation "directly conflicts with and violates the exclusive benefit rule" and that "a municipal ordinance that is in direct conflict with a state statute is preempted by state law" (App 296a-297a). The County concedes that portions of its ordinance cannot stand if they conflict with PERSIA and debates only whether the exclusive benefit rule has been violated.

The County's mantra in claiming that there was no violation is that the "assets never left the Retirement System, and always remained for the exclusive benefit of participants and their beneficiaries" (County Brief 32, caption (D)(1)(a)). But as the Court of Appeals pointed out, even though the transferred assets

> once part of the IEF and now [because of the 2010 Ordinance] part of the defined benefit plan assets on the accounting records, were still to be used for the benefit of participants and their beneficiaries in the form of regular pension payments, the County also enjoyed an enormous cost savings benefit. Accordingly, it cannot be said that the assets of the system were held or used "for the *exclusive* benefit of the participants and their beneficiaries." (App 298a, quoting from MCL 38.1133(6); emphasis by the Court of Appeals.)

The County takes issue with this statement, accusing the Court of Appeals of taking the words "exclusive" and "benefit" out of context, and claiming that what the language really means is only that the System's assets may not be "shared with others" (County Brief 32-33). The County cites no on-point authority for this proposition, relying instead on unobjectionable general statements in off-point cases about reading statutory language in context (*id.* 32 n.24). According to the County, "exclusive benefit" must be read in the narrowest possible fashion, so that there can be no violation if dollars do not physically leave the Retirement System.

To the contrary, "exclusive benefit" has a natural, plain meaning, and it is the meaning attached to it by the Court of Appeals. To be sure, not every conceivable benefit is encompassed, but none of the cases that define the exceptions—called "incidental benefits"—involve anything resembling the avoidance of millions in mandatory ARC to the direct benefit of the County and the direct detriment to the Retirement System's beneficiaries.

The County no longer argues, as it did in the lower courts, that PERSIA protects only defined benefit assets, and that the funds in the Retirement System's IEF reserve were not trust assets but some kind of unprotected "surplus" the County could use to satisfy its minimum funding obligation. The County now concedes that the exclusive benefit rule protects *all* "the assets of the system," not just *some* of its assets:

> The system shall be a separate and distinct trust fund and *the assets of the system shall be for the exclusive benefit of the participants and their beneficiaries* and of defraying reasonable expenses of investing the assets of the system. MCL 38.1133(6) (emphasis added).

"Assets," in turn is defined broadly in PERSIA to mean "the total of the cash and investments of a system valued at market." MCL 38.1132a. "System" means "a public employee retirement system created and established by...any political subdivision of this state." MCL 38.1132e. Accordingly, *all* assets of the Retirement System—defined benefit assets and IEF reserve assets alike—are fully protected by PERSIA.[17] The County is forbidden by the exclusive benefit rule and MCL 38.1140m from taking them directly and it is equally forbidden from using them indirectly by passing an ordinance that says, in effect, "the Retirement System shall make an accounting entry reallocating certain of its trust assets from one of its reserves to another and the County then shall be entitled to underpay its ARC by the same amount, dollar for dollar."

As the Court of Appeals put it, the 2010 Ordinance, rather than reduce the ARC—which of course the County could not do—instead reduced

> the amount of money that the County had to take directly from its own coffers in order to satisfy the ARC obligation. The $32 million savings, which we decline to characterize as a minor or an incidental benefit, freed up County funds for other uses. To describe the impact of the 2010 ordinance as not being beneficial to the County is to wholly ignore the motive behind enacting the ordinance in the first place and the resulting fiscal reality. (App 298a)

The Court noted that §141-32(f) of the 2010 Ordinance, concerning attempts to "*reimburse* the Inflation Equity fund of $32 million dollars" (App 298a; emphasis by the Court), was itself an admission of "an original benefit conferred upon and used by the reimbursing party" (*id.*). The

[17] The Court of Appeals agreed that "the phrase 'assets of the system' is clearly broad in scope and comprehensive, and it would necessarily encompass all assets held by the Retirement System, including the defined benefit plan assets and the assets in the IEF" (App 297a).

Court also noted that the County had admitted in 2010 that it faced "budget challenges" that could result in layoffs and curtailed services (*id.* 298a n.20).

The County's answer to all this is that its motive in adopting the 2010 Ordinance is irrelevant. But the Court of Appeals did not find a benefit to the County because of motive; that was merely corroborating background information. The benefit is obvious, and the Court was observing that the County was being disingenuous in denying it.

In the Court of Appeals, as here, the County writes inconsistently on the question of benefit. It both concedes and denies that it received a benefit. No concession is necessary, however, because the benefit speaks for itself. The County avoided paying $32 million that it owes to the Retirement System.

As noted earlier, the County's argument boils down to the simple claim that there can be no violation of the exclusive benefit rule unless assets are physically removed from the Retirement System. The County's logic means that, instead of adopting the 2010 Ordinance, it hypothetically could have borrowed $32 million from a bank guaranteed by Retirement System assets without violating the exclusive benefit rule, because no assets would leave the System (unless the County defaulted on the loan). Even the County, however, would admit that it cannot borrow against Retirement System assets. But what it did was no better—the 2010 Ordinance was simply an IOU made out to the System, as is made clear by §141-32(f)'s directive to explore "reimburs[ing] the inflation equity fund of $32,000,000.00" (338a).

The County's final argument for claiming that the 2010 Ordinance does not violate the exclusive benefit rule is based on a sentence contained in MCL 38.1140m, which the County claims is an "example" of PERSIA authorizing "the very sort of offset that the Court found MCL

38.1133(6) to *prohibit*" (County Brief 36; emphasis by the County). MCL 38.1140m serves a variety of purposes, but none of them helps the County.

This section, entitled "Employer contribution," starts off by requiring the Trustees, as the parties "vested with the general administration, management, and operation of a system" to confirm each year, in the annual actuarial valuation and the summary annual report, that they have assessed the proper ARC against the County and confirm in the annual report that they have *received* it. MCL 38.1140m. The section then goes on to define the ARC in the same way that the annual funding paragraph of the Pension Clause defines it. The section next requires that the amortization period used in calculating the ARC not exceed 30 years. After a sentence addressed to state plans that does not apply here, MCL 38.1140m provides: "In a plan year, any current service cost payment may be offset by a credit for amortization of accrued assets, if any, in excess of actuarial accrued liability." This is the sentence the County claims to believe shows that it may enact an offset by ordinance.

The County repeats this "substantially similar offset" argument at the end of its brief (County Brief 48-49), and the Retirement System responds to it at the end of this brief, *infra* at 47-48. There are no similarities because the PERSIA offset applies only when the System has a surplus and only when the Trustees choose to provide it. The County accuses the Court of Appeals of failing to construe MCL 38.1133(6) "in harmony with MCL 38.1140m" (County Brief 36), assuming there is some conflict that needs to be resolved. But the provisions do not conflict. The County claims that the "only difference" between the 2010 Ordinance and the offset provision in MCL 38.1140m is the nature of the assets involved (harking back to its abandoned argument that not all the Retirement System's assets are held in trust and covered by

PERSIA), but in doing so the County ignores the *real* differences: there is no surplus and the Trustees did not choose to permit this offset.

D. The County's remaining "exclusive benefit" arguments, based on ERISA and cases in other jurisdictions, lack merit

Throughout this litigation, the County has premised its argument against a violation of the exclusive benefit rule on a California case, *Claypool v Wilson*, 4 Cal App 4th 646, 6 Cal Rptr 2d 77 (1992), and the explanation of "incidental benefit" in *Hughes Aircraft v Jacobson*, 525 US 432, 119 S Ct 755, 142 L Ed 2d 881 (1999), quoting from *Lockheed Corp v Spink*, 517 US 882, 116 S Ct 1783, 135 L Ed 2d 153 (1996). In this Court, the County continues to devote seven pages to these two cases (County Brief 37-44). Although the Court of Appeals already has done a very thorough job of demonstrating why these cases do not help the County (App 300a-304a), the Retirement System will respond as well. The County relies on *Hughes* in discussing the concept of "incidental benefit," but *Hughes* itself is not an incidental benefit case and merely cites to and relies upon *Lockheed*. *Lockheed*'s list of incidental benefits, notably, does not include avoidance of an employer's mandatory funding obligation. *Hughes* also cites *Comm'r of Internal Revenue v Keystone Consol Indus, Inc*, 508 US 152, 113 S Ct 2006, 124 L Ed 2d 71 (1993), a case the County never cites, which highlights the strict limits on the manner in which mandatory funding obligations are met. *Keystone* is discussed below in the third section of argument concerning "prohibited transactions."

To repeat a point made already by the Court of Appeals (App 300a-301a, 303a n.26), ERISA cases and cases from other jurisdictions are not binding on a Michigan court analyzing Michigan public pension law under PERSIA. The plain language of MCL 38.1133(6), alone, compels the result reached by the Court of Appeals (300a). With that said, an examination of the

County's cases reveals that they are, for the most part, consistent with the decision of the Court of Appeals here and, where they appear to vary, they are distinguishable.

1. *Claypool*: Replacing one benefit with another

Claypool, a case seldom cited outside California and never before in Michigan, dealt with amendment of a state pension statute by a state legislature, not the relationship of the state pension statute to a local ordinance. Unlike here, the only restrictions on the *Claypool* legislation were those established in California's constitution. Indeed, *Claypool* precipitated a change in California's constitution that further protected plan members from plan sponsors.[18] The County says that *Claypool* involved "a credit and offset" provision that was "functionally the same" as the 2010 Ordinance (County Brief 42), but that is inaccurate.

Claypool dealt with a COLA benefit (the "Boatwright benefit") initially established in 1980 when the California system had a huge $1 billion surplus, later to grow to $2 billion. The enacting statute *required* that recipients be told that the benefit "may be available for only a limited period of time." 4 Cal App 4th at 655. In 1982, new legislation expanded and extended

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[18] There are significant differences between Michigan and California law. Michigan plan fiduciaries, for example, are charged with discharging their duties solely in the interest of the participants and the beneficiaries, while defraying administrative expenses, MCL 38.1133(3), but in California there is yet another constitutionally-mandated duty—"minimizing employer contributions." Calif Const, art XVI, §17(b). As a result of *Claypool*, Californians voted to amend the constitution to change §17. As amended, the California Constitution clarifies that discretion now resides in the retirement board and that the board's duty to members and beneficiaries "***shall take precedence over any other duty***." §17(b) (emphasis added). Although, under the California State Employees' Retirement System (PERS), "[t]he reduction of employer contributions," Gov Code §20203.3, remains a proper purpose for the expenditure of retirement funds, that purpose is now expressly subservient to the retirement board's constitutional duties to its members and beneficiaries. The County briefly notes the constitutional change, claiming the provision is "substantively the same" (County Brief 42 n.30). It is not. This significant change in post-*Claypool* California law—making it more closely resemble Michigan's—has been noted in recent California cases. *See, e.g. O'Neal v Stanislaus Cty Employees' Retirement Ass'n*, 2012 WL 1114677 (Cal App, 5th Dist 2012) (footnote 9 discussing *Claypool*) (Tab F).

the benefit (the "75% of purchasing power floor"), but again stated that it "may be available for only a limited period of time" and established an express sunset provision, effective January 1, 1989. *Id.* 656. Yet a third version of the benefit was established in 1988 (the "Extraordinary Performance Account benefit"). *Id.* 657. Because of vesting over the years as employees retired, all three versions were in use until 1991, when the challenged statute repealed them and replaced them with an alternative COLA program. *Id.* 657-658.

The *Claypool* court held that employees who retired before January 1, 1989, had no vested contract interest in the continuation of the benefit, because of the sunset provision. The court presumed, however, that those who retired after that sunset date *did* have a constitutionally protected contract benefit. *Id.* 665. The *Claypool* court analyzed at length whether the replacement program was a comparable alternative to the repealed programs, concluding that it was. No such analysis was undertaken by the circuit court or Court of Appeals here, for obvious reasons. There was no comparable alternative benefit—"the 13th check program was eviscerated" (App 304a) and replaced with an empty promise to look into possible reimbursement.

The County claims that the Court of Appeals misunderstood the significance of *Claypool* (County Brief 42), but it is the County that overlooks key differences in the facts and law, not to mention the California reaction to *Claypool*, which was Proposition 162, the Pension Protection Act of 1992 (*see* footnote 15 at 36, *supra*). In the present case, the Court of Appeals chose its words carefully in referring to *Claypool* as an "aberration" (App 304a).

2. *Hughes* and *Lockheed*: Avoiding a mandatory payment is not an incidental benefit

Claypool is not a case explaining what "incidental benefit" means in pension law. For that, the County relies on *Hughes, supra* (County Brief 38-41). *Hughes* is an ERISA case, not a public pension case, but the two statutes are similar with regard to the exclusive benefit rule, often called the anti-inurement rule in ERISA cases. (*See* ERISA §403(c)(1), 28 USC 1103(c)(1), which uses both phrases.) The County stresses "the factual parallels between *Hughes* and the present case" (County Brief 39), but it is the differences that are striking. *Hughes* is strictly a case about a pension *surplus* built in part through participant contributions and a plan sponsor's rights to deal with it in plan amendments *adding* benefits. The 2010 Ordinance, in contrast, added no benefit and was adopted when the Retirement System had no surplus. Indeed, as the Court of Appeals explained, the effect of the 2010 Ordinance

> was as if the County Board reached into the pockets of the Retirement System, retrieved Retirement Systems funds previously allocated to the IEF for 13^{th} checks under the County Board's very own ordinance, and then handed the funds back to the Retirement System for purposes of the ARC, pretending like it was County money and depriving the Retirement System of $32 million. (App 302a).

Hughes does, however, discuss what constitutes a permissible "incidental benefit" to employers:

> Among the 'incidental' and thus legitimate benefits that a plan sponsor may receive from the operation of a pension plan are attracting and retaining employees, paying deferred compensation, settling or avoiding strikes, providing increased compensation without increasing wages, increasing employee turnover, and reducing the likelihood of lawsuits by encouraging employees who would otherwise have been laid off to depart voluntarily.

Hughes, 525 US at 445, *quoting Lockheed*, 517 US at 893-894. The receipt of such benefits is not a breach of fiduciary duty or improper "inurement" of a benefit. *Hughes*, 525 US at 445. Fundamentally, an "incidental benefit" is "incidental" to some direct benefit received by plan participants. But as the County conceded in March 2014, when a justice of this Court asked its counsel whether participants received any benefit, there was no such benefit.

The kind of indirect or collateral benefits described by the United States Supreme Court in *Lockheed* (*Hughes* itself is not an "incidental benefit" case) are *nothing* like the direct $32 million benefit the County obtained by adopting the 2010 Ordinance. Incidental benefits result from simply operating or sponsoring a tax-qualified retirement plan, not amending an underfunded plan to avoid paying the necessary ARC. The anti-inurement rule is intended precisely to prevent the employer's use of assets accumulating in trust and pension funds. An incidental benefit "involves a *quid pro quo* between the employer and the participant" (*Lockheed*, 517 US at 894), but here there is only a *quid* without any *quo* between the County and the plan participants. No pension case, ERISA or otherwise, has ever found avoidance of the mandatory annual funding obligation to be an incidental benefit.[19]

Nothing is more fundamental to pension law than the plan sponsor's satisfaction of its mandatory funding obligation. The satisfaction must be full in amount and appropriate in manner. It is the Trustees' duty under MCL 38.1140m to see that payment is made. The Retirement System discusses this more fully in the next section of argument on "prohibited transactions," where we will discuss one of the cases cited in *Hughes*, namely *Keystone*.

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19 The County's other (purportedly contrary) authorities are either easily distinguishable or not contrary. One example will suffice. In *Holliday v Xerox Corp*, 732 F2d 548 (CA 6 1984), the employer, Xerox, had two pension funds, an optional account and a retirement account, that were used to purchase annuities for retiring employees. These were private plans governed by ERISA, so Xerox could administer and manage these plans, unlike the case at bar, where PERSIA controls. Neither plan guaranteed a minimum pension floor. Xerox established a third pension plan to do that, called the Retirement Income Guarantee Plan (RIGP). As an *additional* benefit, the RIGP guaranteed the greater of the income from the retiring employee's own retirement account or a minimum annual pension. Annuity payments made under the retirement account were subtracted as an offset upon retirement to determine whether the additional RIGP payment was due and how much it would be. Plaintiffs were a class of employees formerly employed by companies acquired by and merged into Xerox who had deposited their former pension funds into the Xerox optional account. Xerox transferred those funds to the employees' retirement accounts so they would be offset upon retirement to determine if an additional RIGP payment was due and how much it would be. Plaintiffs claimed this transfer benefited Xerox by reducing the amount it had to contribute to the RIGP. The district court rejected this claim, as did the Sixth Circuit. The offset calculation for the additional benefit in *Holliday* was nothing like the offset against the ARC payment mandated by the 2010 Ordinance, which directly reduced, dollar-for-dollar, the amount the County paid in ARC; a prohibited benefit to the County as employer. The Xerox transfer had no such effect. For both employees whose annuities exceeded the RIGP amount and those whose annuities did not, the transfer had the "obvious primary purpose and effect of benefitting the employees." *Id.* 551.

III. THE 2010 ORDINANCE VIOLATES PERSIA'S PROHIBITED TRANSACTION RULE BECAUSE IT REQUIRED THE TRUSTEES OF THE RETIREMENT SYSTEM TO USE TRUST ASSETS TO DIRECTLY AND INDIRECTLY BENEFIT THE COUNTY, A PARTY IN INTEREST, DURING A PERIOD OF UNDERFUNDING

A. The standard of review is de novo

As noted earlier, at pages 18 and 31, the parties and the lower courts all agree that the standard of review for issues of statutory construction is de novo.

B. PERSIA's "prohibited transaction" rule

The Court of Appeals found that the 2010 Ordinance violated PERSIA's "prohibited transaction" rule, MCL 38.1133(6)(c), which makes it unlawful for the Retirement Commission to "cause the system to engage in a transaction" if it involves, "either directly or indirectly," a "use by or for the benefit of the political subdivision sponsoring the system of any assets of the system for less than adequate consideration" (App 304a-305a, quoting the statute). The County tackles this holding at the end of its brief (County Brief 44-49).

PERSIA requires that (a) the Retirement System "shall" be a separate and distinct trust fund, and that (b) the assets of the Retirement System "shall" be for the exclusive benefit of the participants and beneficiaries. MCL 38.1133(6). "The word 'shall' is unambiguous and is used to denote mandatory, rather than discretionary, action." *City of Detroit-2006,* 270 Mich App at 80. To protect the systems' trust assets from parties in interest (including the County), this section absolutely precludes, either directly or indirectly, the Trustees from engaging in any transaction involving (a) the lending of money or other extension of credit from the Retirement System to the County, without the receipt of adequate security and a reasonable rate of interest, or (b) the "use by or for the benefit of" the County of any of the trust assets of the Retirement System for less than adequate consideration. MCL 38.1133(6)(b) & (c).

In this case, the County has obtained the "use" or "benefit" of over $32 million of the Retirement System's trust assets by adopting an ordinance that instructs the Trustees to debit that sum from the IEF reserve and credit the defined benefits assets and then to pretend—it is difficult to put it otherwise—that the $32 million had been paid by the County in satisfaction of its ARC. Because the Retirement System received no consideration for this transaction, other than an empty promise to consider the feasibility of coming up with the money later, it is prohibited by PERSIA. MCL 38.1133(6)(c).

C. The 2010 Ordinance violates the prohibited transaction rule

The Court of Appeals held that the 2010 Ordinance violated this rule (App 304a-305a). The Court also noted that the parallel ERISA provision discussed in *Hughes* would compel the same result (*id.* 304a) The County's answer, in a nutshell, is that there was no "transaction" and that there cannot be a transaction without a third party. The County's attempt to limit "transactions" to exclude what it calls "intra-system transfers" (County Brief at 44-45) is unsupported by authority and ignores the corresponding offset against the County's mandatory funding obligation. This section of the County's brief (*id.*) does not cite a single case and merely cites the PERSIA provision. But PERSIA's mandate to the Trustees is that they "shall not cause the system to engage in a transaction" if they know that the transaction is any of the following, either directly or indirectly: (a) certain sales, exchanges or leases, (b) an extension of credit from the system to a party in interest (*e.g.*, the County) "without the receipt of adequate security and a reasonable rate of interest," (c) "[a] transfer to, or use by or for the benefit of, the political subdivision sponsoring the system [*i.e.*, the County] of any assets of the system for less than adequate consideration," or (d) furnishing anything, including services, to a party in interest (again, the County), "for less than adequate consideration." MCL 38.1133(6). (This last subsection, it should be noted, illustrates that a prohibited transaction does not require that trust assets "leave the system." If the County occupied offices provided by the Retirement System without paying adequate rent, it would be a prohibited transaction.)

The plain language of the statute shows that "transaction" does not have the limited meaning contended for by the County. Looking first at subsection (c), the statute says in so many words that the transaction does not have to be a transfer of assets. The "ors" in "transfer to or a use by or for the benefit of" are disjunctive. Even if the transfer of $32 million from the IEF reserve into the defined benefit assets were not a "transfer"—something the Retirement System does not concede and the Court of Appeals did not hold—the corresponding offset was either directly or indirectly (both, in fact) a "use...for the benefit of" the County.

The effect of the 2010 Ordinance, with its promise to think about reimbursing the System for the $32 million, was likewise an extension of credit to the County (*i.e.*, a party in interest)[20] with no security and no interest, violating MCL 38.1133(6)(b). Although the County itself and the County Commission are not investment fiduciaries, the Court of Appeals correctly concluded that "they set into motion the prohibited transaction [which was] a sham transaction involving, *effectively*, an unlawful transfer of assets to the County for use to satisfy obligations relative to the ARC" (App 305a, emphasis by the Court of Appeals, citing *Hughes*, 525 US at 445).

When PERSIA and ERISA say that certain transactions are prohibited, they mean it. Transactions with even a *potential* for unfairness are prohibited. In the case of ERISA, parallel provisions in the Internal Revenue Code add economic teeth to these prohibitions. A good example, and a case cited in *Hughes*, is *Comm'r of Internal Revenue v Keystone Consol Indus, Inc*, 508 US 152, 113 S Ct 2006, 124 L Ed 2d 71 (1993). In *Keystone*, the IRS (tasked with

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[20] Contrary to what the County has suggested, the County *is* a "party in interest" for *all* purposes of the prohibited transaction rule, not just subsection (c) of MCL 38.1133(6). The other subsections limit the County as well.

enforcement under the IRC and ERISA), undertook action against the plan sponsor. The plan sponsor had attempted to satisfy its minimum funding obligation in part by transferring real property that it owned (truck terminals) to its retirement plans. The employer owned the terminals outright, with no liens, and transferred them at fair market value (purportedly, although the accuracy of the valuation did not figure in the Supreme Court's decision). ERISA and the IRC had a rule against using such property transfers to satisfy annual funding obligations if the property was encumbered, but the employer contended the result should be different if the property was free-and-clear.

The Supreme Court held otherwise. 508 US at 160-161. It was no answer to suggest that the retirement system could sell the properties, because of real estate commissions, problems finding buyers, and similar issues. It would be one thing for an employer to provide its pension plan with real property that was not linked to a diminution of the annual funding obligation, but otherwise the potential for abuse is too great and the transaction is prohibited. The goal is first and foremost to protect pension beneficiaries and their families from any transaction that might leave them less secure than if the annual required contribution were received in cash. Neither the employer nor the plan fiduciaries can take any action inconsistent with that goal. The bar is absolute, and no actual prejudice need exist. In the case at bar, of course, there was actual prejudice because plan participants' 13th checks were diminished and the Retirement System did not receive $32 million to which it was entitled.

As discussed in *Keystone*, the phrase "direct or indirect" is broad language intended "to expand, not limit, the scope of the prohibited-transaction provision." If ERISA case law is useful in understanding PERSIA, *Keystone* is consistent with the Court of Appeals. The benefit to the County, of course, was that under the 2010 Ordinance the County was deemed to have satisfied its mandatory funding obligation to the extent of the corresponding offset, diminishing the amount it actually paid by the same amount. The "satisfaction of a monetary obligation" and the "diminution of the employer's funding obligation" are certainly transactions under ERISA. *Keystone*, 508 US at 158, 159.

Keystone is just one example. *See, e.g., Baizer v Comm'r,* 204 F3d 1231 (CA 9 2000) (prohibiting the use of accounts receivable in diminution of employer's funding obligation); *Peek v Comm'r*, 140 TC 12, 2013 US Tax Ct LEXIS 13 (2013) (Tab G) (loan guaranties prohibited); *Rollins v Comm'r*, TC Memo 2004-260 (Memo Dec 2004) (Tab H) (prohibited transfers not saved even if plan benefits and there is no direct asset transfer). The 2010 Ordinance compelled a very plainly prohibited transaction. The Court of Appeals reached the right result for the right reasons.

D. MCL 38.1140m does not help the County

The County briefly argues that MCL 38.1140m "expressly permits transfers and offsets similar to that under the 2010 ordinance" (County Brief 36-37, 48-49). In making this claim, allegedly in support of both its "exclusive benefit" and "prohibited transaction" argument, the County relies on one sentence in a provision that, overall, authorizes *only* the "governing board" (*i.e.*, the Trustees) to calculate and impose the annual required contribution and permit an offset: "In a plan year, any current service cost payment *may* be offset by a credit for amortization of accrued assets, if any, *in excess of* actuarial accrued liability" MCL 38.1140m (emphasis added).

MCL 38.1140m does not support the County's argument for two reasons. First, the language the County relies upon refers only to discretionary action by the Trustees, not the County. If there were a surplus, the Trustees could (but need not) grant an offset against the County's ARC. *Detroit Police Officers Ass'n* (Tab D). Second, the exception applies only when plan assets exceed "actuarial accrued liability." It is undisputed that the System's assets did not exceed its accrued liabilities in 2010 and had not done so for a number of years preceding 2010.

It is MCL 38.1133(6) that establishes the general rule, to which the sentence in MCL 38.1140m on which the County relies is but an exception. The exception cannot be read to apply at a time when the System is underfunded. Moreover, any judicial "interpretation" that adds additional exceptions to Section 13(6) would violate the well-established rule of statutory construction known as *expressio unius est exclusio alterius*, the expression of one thing is the exclusion of another. *Feld v Robert & Charles Beauty Salon*, 435 Mich 352, 362-364 (1990). The creation of statutory discretion afforded to the Retirement Commission to extend an offset during periods of overfunding, far from implying a right to do so during periods of underfunding, implies the opposite—the absence of any such right, even on the part of the Retirement Commission, much less the County itself. While a rule of construction is not a rule of law, "[it] is a product of 'logic and common sense.' It expresses the learning of common experience that when people say one thing they do not mean something else." 435 Mich at 363.

CONCLUSION AND RELIEF REQUESTED

This has always been a simple case. The County tried to solve a financial problem it faced in 2010, as the deadline for balancing its budget drew near, by enacting an ordinance that seemed to reduce its debt to its Retirement System by $32 million. The Trustees protested. The 2010 Ordinance barely passed on an 8-7 vote, and the Trustees brought this action as their fiduciary duties required them to do. The County, relying on the Ordinance, failed to pay $32 million in ARC it owed the Retirement System, thus violating the Pension Clause, PERSIA, and its Charter. The Pension Clause was adopted and PERSIA was enacted in significant part to prevent governmental plan sponsors from failing to pay their ARC.

The IEF reserve was reduced from $44 million to $12 million, which meant that the Trustees had to start parceling out increasingly smaller 13th checks to keep from exhausting the reserve. The reserve is down to about $3 million now and will be less before this appeal is decided in 2015. The plan participants who are most affected by this are, by and large, the same people who can least afford not to receive inflation protection.

The Court of Appeals is correct that PERSIA was violated because the 2010 Ordinance required a prohibited transaction in which a use of trust assets substantially benefited the County. This Court has asked a question that in some ways is even more fundamental—because the County's authority is derivative and limited, what is the source of its right to move assets from the IEF reserve? The answer, of course, is that there is no such source and no such power.

For all these reasons, and for the additional reasons in the Court of Appeals' opinion, the Retirement System respectfully requests that this Court affirm the result reached by the Court of Appeals and remand to the trial court for entry of an order striking down those portions of the 2010 Ordinance declared invalid by the Court of Appeals and requiring the County to reimburse the Retirement System for all losses incurred by it in consequence of the enactment of the 2010 Ordinance, including the nonpayment of $32 million in ARC and the illegally compelled movement of Trust assets, along with such other and further relief as the Court deems appropriate.

Respectfully Submitted,

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Dated: July 22, 2014

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A

Sec. 6.111. Retirement system.

The Wayne County Employees Retirement System created by ordinance is continued for the purpose of providing retirement income to eligible employees and survivor benefits. The County Commission may amend the ordinance, but an amendment shall not impair the accrued rights or benefits of any employee, retired employee, or survivor beneficiary.

Compiler's comments—The Wayne County Retirement Ordinance was republished on November 20, 1986 (Ordinance 86-486) to incorporate all prior amendments, conform the ordinance with federal law, remove outdated provisions, and reconcile inconsistent terminology. This was done again on November 17, 1994 in Ordinance 94-747, which has since been amended by Ordinances 97-728, 98-335, 2000-536, 2002-1103, 2002-1147, 2003-124, 2005-924 and 2010-514. (Code Chapter 141)

It has been ruled that those provisions of the Wayne County Retirement Ordinance which provided for "20 and out" benefits for non-union employees were invalid because in conflict with MCL 46.12a which requires that a county employee have at least 25 years of service to become eligible for retirement benefits if less than 60 years of age. (Donald Gray vs. Wayne County Retirement System, et al Civil Action No. 84-401 649 CK, August 31, 1984, Third Circuit Judge Roland Olzark presiding.)

Sec. 6.112. Retirement Commission.

The Retirement Commission is composed of 8 members: The CEO or the designee of the CEO, the chairperson of the County Commission, and 6 elected members. The members must be residents of Wayne County. Four members shall be active employees elected by active employees of the County in the manner provided by ordinance and 2 members shall be retired employees elected by retired employees of the County in the manner provided by ordinance. The term of the elected members is 4 years. The Retirement Commission shall administer and manage the Retirement System. The costs of administration and management of the Retirement System shall be paid from the investment earnings of the Retirement System.

Compiler's comments—In Opinion 88-012, the Corporation Counsel advised that the Retirement Commission was without authority to amend the Retirement Ordinance or to expand benefits beyond those authorized by the Ordinance.

At the general election held on November 6, 2012, voters rejected by a vote of 302,104 (yes) to 321,515 (no) a proposed amendment to this Section. The ballot question certified to the County Clerk read:

"Shall Section 6.112 of the Wayne County Home Rule Charter be amended to expand the Wayne County Retirement Commission's membership from 8 to 9, adding as a member the Wayne County Treasurer or his or her designee; and also to authorize the Chairperson of the Wayne County Commission, who is also a member of the Wayne County Retirement Commission, to appoint a person to serve as his or her designee on the Retirement Commission; and further to allow employees and retirees of the Wayne County Airport Authority to vote for and serve as members of the Wayne County Retirement Commission with no more than one member being an airport employee or retiree until such time as the Airport Authority establishes its own retirement system or pension plan?"

Sec. 6.113. Financial management.

The financial objective of the Retirement System is to establish and receive contributions each fiscal year which, as a percentage of active member payroll, are designed to remain approximately level from year to year. Specifically, contributions shall be sufficient to (i) cover fully costs allocated to the current year by the actuarial funding method, and (ii) liquidate over a period of years the unfunded costs allocated to prior years by the actuarial funding method. The period of years used in the application of item (ii) shall not exceed 35 years for unfunded amounts in existence December 1, 1982, 25 years for unfunded amounts resulting from benefit changes effective on or after December 1, 1982, and 15 years for experience gains and losses during years ending after November 30, 1981. Contributions made after November 30, 1981, which are in excess of the minimum requirement, may be used to reduce contribution requirements in a subsequent fiscal year. The actuarial funding method must produce contribution requirements which are not less than those produced by the individual-entry-age-normal-cost-actuarial method.

Sec. 6.114. Employment of actuary.

The actuary employed by the Retirement System must have 5 years experience as a practicing actuary.

B

Sec. 141-32. Inflation equity programs.

(a) The retirement commission shall establish a reserve for inflation equity effective November 30, 1985.

(b) The retirement commission shall credit the reserve with the following amount at the end of each fiscal year: a portion of the excess, if any, of the rate of return on the actuarial value of retirement system defined benefit assets over the rate established for this purpose by the retirement commission, multiplied by the actuarial present value of pensions being paid retired members and survivor allowance beneficiaries, both as reported in the annual actuarial valuation. The retirement commission shall establish the portion of the excess rate of return used in this calculation.

(c) The retirement commission may, not more frequently than once per year, distribute to retired members and survivor beneficiaries a percentage of the balance in the reserve for inflation equity. The retirement commission may also use a portion of the distribution to provide a minimum permanent pension. The percentage of the balance to distribute shall be selected by the retirement commission.

(d) The retirement commission may restrict the distribution and/or the minimum permanent pension to retired members and survivor beneficiaries having a pension effective date prior to dates selected from time to time by the retirement commission.

(d) The formula for the distribution shall be as from time to time determined by the retirement commission and shall take into account the period of retirement and period of credited service.

(Ord. No. 94-747, § 26.01, eff. 12-2-94; Ord. No. 2000-536, § 1, eff. 9-7-00)

Sec. 141-36. **Financial objective; contribution certification.**

a) *Financial objective.*

(1) The financial objective of the retirement system is to receive contributions each fiscal year which, as a percentage of member payroll, are designed to remain level from year to year and are sufficient to:

a. Fund the actuarial cost allocated to the current year by the actuarial cost method; and

b. Fund unfunded actuarial costs allocated to prior years by actuarial cost method over a period or periods of future years as determined by the retirement commission based on consultation with the actuary and approval by resolution of the county commission.

(2) Contribution requirements for defined benefits shall be determined by annual actuarial valuation.

(3) The excess of actuarial contributions made for periods after November 30, 1981 over the minimum required by subsection (a) and (b) may be used to reduce contributions required for subsequent years.

(4) Contribution requirements of the county for defined contribution benefits shall be in accordance with the county contribution program specified for a member's coverage group. The contribution requirement may be actuarially discounted for anticipated forfeitures.

b) *Certification of contribution requirement.* The retirement commission shall certify to the county executive the amount of annual contribution needed to meet the financial objective.

(Ord. No. 94-747, §§ 30.01, 30.02, eff. 12-2-94; Ord. No. 2005-924 § 1, 10-6-05).

C

Sec. 141-35. Retirement commission.

(a)

Composition.

(1)

The retirement commission shall consist of the following eight individual trustees:

a.

The chairperson of the county commission.

b.

The county executive or the individual designated by the executive to serve in the executive's place. The designation shall be in writing and filed with the retirement commission.

c.

Four members of the retirement system, who are residents of the county, to be elected by the members of the retirement system. Each member trustee shall be from a different county department, as provided in the county Charter on January 1, 1987, that is: the county commission; prosecuting attorney; sheriff; county clerk; county treasurer; register of deeds; corporation counsel; personnel; management and budget; health; public works; office of public services; and senior citizens. Employees of all other county agencies shall be considered collectively to be employees of one additional county department for the purposes of this provision. This restriction upon eligibility to serve as a trustee shall not be affected by changes made in the organization and administration of executive departments by an executive reorganization plan. The elections shall be conducted in accordance with procedures adopted by the retirement commission.

d.

Two retired members, who are residents of the county, to be elected by the retired members and beneficiaries. The elections shall be conducted in accordance with procedures adopted by the retirement commission.

(2)

Retirement commission trustees shall serve without compensation for their service as a retirement commissioner but shall be reimbursed by the retirement system for their actual and necessary expenses incurred in the performance of the duties of retirement commissioner. Absence from work on account of retirement commission duties is authorized and shall be treated so that the individual suffers no loss of pay or benefits.

(b)

Term of office; oath of office; vacancies.

(1)

The term of office of the elected member trustees shall be four years, one such term of office to expire at the end of each calendar year. The term office of the elected retired member trustees shall be four years, one such term to expire at the end of each even-numbered calendar year.

(2)

Each trustee shall, prior to taking office, take an oath of office administered by the county clerk.

(3)

A vacancy shall occur on the retirement commission if a member elected trustee ceases to be a member or becomes employed in a county department in which is employed another member elected trustee or ceases to be a county resident or resigns.

(4)

A vacancy shall occur on the retirement commission if a retired member trustee ceases to be a retired member or ceases to be a county resident or resigns.

(5)

A vacancy shall be filled within 90 days, for the unexpired term, in the same manner as the position was previously filled.

(c)

Meetings. The retirement commission shall schedule sufficient meetings to effectively carry out its duties and shall designate the time and place of each meeting. The retirement commission shall adopt rules of procedure. The retirement commission shall select from its membership a chairperson and a vice-chairperson.

(d)

Quorum; record of proceedings. Four trustees shall constitute a quorum at any meeting of the retirement commission. At least four concurring votes shall be required for a valid action by the retirement commission. The retirement commission shall keep a written record of its proceedings.

(e)

Executive secretary. The retirement commission shall appoint an executive secretary. The executive secretary shall be the secretary of the retirement commission and shall be the administrative officer of the retirement commission. The duties of the executive secretary shall be established by the retirement commission.

(f)

Employees of retirement commission; employment of outside services.

(1)

The retirement commission may employ persons in the county classified service.

(2)

The corporation counsel shall be the legal advisor to the retirement commission.

(3)

The retirement commission shall designate an actuary who shall advise the board on the actuarial operation of the retirement system and on such other subjects as the retirement system may determine. "Actuary" shall mean a member of the American Academy of Actuaries or an individual who has demonstrated the educational background necessary to effectively render actuarial advice to the retirement system and who has at least five years of relevant public employee retirement system actuarial experience. A partnership or corporation may be designated as actuary if the duties of actuary are performed by or under the direct supervision of an individual who meets the preceding requirements.

(4)

The retirement commission shall employ a medical director who is licensed by the State of Michigan to engage in the practice of medicine.

(5)

The retirement commission is authorized and empowered to employ such other persons and services as it requires to effectively carry out its duties.

(g)

Reports.

(1)

The retirement commission shall prepare an annual report for each fiscal year. The annual report shall contain information about the financial, actuarial and other activities of the retirement system during the fiscal year. A copy of the annual report shall be furnished the county commission within 300 days of the end of the fiscal year.

(2)

A summary of the annual report shall be made available to the members, vested former members, retired members and beneficiaries of the retirement system.

(h)

Investment authority. The retirement commission is the trustee of the assets of the retirement system. The retirement commission has the authority to invest and reinvest the assets of the retirement system subject to all terms, conditions, limitations and restrictions imposed by the state on the investments of public employee retirement systems. The retirement commission may employ investment counsel to advise the board in the making and disposition of investments. In exercising its discretionary authority with respect to the management of the assets of the retirement system, the retirement commission shall exercise the care, skill, prudence, and diligence, under the circumstances then prevailing, that an individual of prudence acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and similar objectives.

(i)

Use of retirement system assets; prohibited actions.

(1)

The assets of the retirement system shall be held and invested for the sole purpose of meeting the obligations of the retirement system and shall be used for no other purpose.

(2)

Members of the retirement commission and its employees are prohibited from:

a.

Having a beneficial interest, direct or indirect, in an investment of the retirement system.

b.

Borrowing from the retirement system.

c.

Receiving any pay or emolument from any individual or organization, other than compensation for personal services or reimbursement of authorized expenses paid by the retirement system, providing services to the retirement system.

(3)

No payment shall be made unless it has been authorized in advance by a specific or continuing resolution of the retirement commission. Authorized payments shall be made by county voucher signed by two persons designated by the retirement commission. An attested copy of the resolution designating the persons and specimen signatures shall be filed with the county treasurer.

(Ord. No. 94-747, §§ 29.01—29.09, eff. 12-2-94)

D

RETIRED DETROIT POLICE AND FIRE FIGHTERS ASSOCIATION INC, Plaintiff-Appellant, v. DETROIT POLICE OFFICERS ASSOCIATION, DETROIT POLICE LIEUTENANTS AND SERGEANTS ASSOCIATION, DETROIT POLICE COMMAND OFFICERS ASSOCIATION, DETROIT FIRE FIGHTERS ASSOCIATION, THE CITY OF DETROIT, and CITY OF DETROIT POLICE AND FIRE RETIREMENT SYSTEM, Defendant-Appellees.

No. 293998

COURT OF APPEALS OF MICHIGAN

2010 Mich. App. LEXIS 2414

December 16, 2010, Decided

NOTICE: THIS IS AN UNPUBLISHED OPINION. IN ACCORDANCE WITH MICHIGAN COURT OF APPEALS RULES, UNPUBLISHED OPINIONS ARE NOT PRECEDENTIALLY BINDING UNDER THE RULES OF STARE DECISIS.

SUBSEQUENT HISTORY: Leave to appeal denied by *Retired Detroit Police & Fire Fighters Ass'n v. Detroit Police Officers Ass'n, 2011 Mich. LEXIS 884 (Mich., May 24, 2011)*

PRIOR HISTORY: [*1]
Wayne Circuit Court. LC No. 08-116128-CL.

JUDGES: Before: WHITECK, P.J., and ZAHRA and FORT HOOD, JJ.

OPINION

PER CURIAM.

Plaintiff, Retired Detroit Police and Fire Fighters Association Inc, appeals as of right an order dismissing its claims of breach of fiduciary duty, breach of contract, and conspiracy to cause breach of fiduciary duty, for lack of standing. We affirm.

I. BASIC FACTS AND PROCEEDINGS

Plaintiff is an association representing the interests of approximately 6,500 retired police officers and fire fighters. Defendants, Police Officers Association (DPOA), Detroit Police Lieutenants And Sergeants Association (DPLSA), Detroit Police Command Officers Association (DPCOA) Association, Detroit Fire Fighters Association (DFFA) are labor unions (collectively, "the Unions") representing, respectively, Detroit police officers with a rank of "Police Officer," Detroit police officers with a rank of "Lieutenant, Sergeant or Investigator," Detroit police officers with a rank of "Inspector or Commander," and all Detroit fire fighters. Defendant city of Detroit Police and Fire Retirement System (Retirement System) provides retirement benefits for retired and deceased police officers and fire fighters and their [*2] beneficiaries. The Retirement System has a board of directors (Board) that is responsible for its operation, management and administration.

As stated in *Policemen and Firemen Retirement System v City of Detroit, 270 Mich App 74, 75, 714 NW2d 658* Mich App (2006), the Board,

> is responsible for the general administration, management, and operation of the Policemen and Firemen Retirement System, which provides retirement and death benefits to active and retired uniformed city employees, their families, and beneficiaries.
>
> * * *
>
> Several Detroit officials and employees sit on the Board, including the mayor or his representative, a city council member, the city treasurer, the police chief, the fire commissioner, three firefighters, and three police officers.

* * *

> Part of the Board's responsibilities is to ensure that the retirement system is properly funded. Accordingly, the Board, after consultation with an actuary, determines the amount of Detroit's annual pension contribution. The plan actuary calculates plan assets and liabilities to determine whether the plan is overfunded or underfunded. The annual contribution Detroit must make to the plan includes present service cost, plus a credit or [*3] additional payment depending on whether the plan is overfunded or underfunded.

On June 26, 2008, plaintiff filed a complaint against the DPOA, the DPLSA, the DPCO, the DFFA and defendant city of Detroit seeking superintending control of the Retirement System [1] to reverse a resolution allowing the city of Detroit a $ 25 million annual credit toward its obligation to fund the Retirement System over the following three years, should the Retirement System remain overfunded. Plaintiff alleged that the Board was overfunded in fiscal year ending June 30, 2006 by over $ 100 million because of an unexpected return on investments. Plaintiff alleged that the Unions and the Retirement System breached their fiduciary duties to plaintiff when various members of the Unions seated on the Board approved the resolution in exchange for the city of Detroit amending the collective bargaining agreement to provide that active employees would be reimbursed for 100 percent of their accumulated sick leave upon their retirement instead of only 70 percent. On appeal, DPCOA and DFFA freely admit that "[i]n 2008, the city again sought an offset to its contribution and offered benefit enhancements in order to encourage [*4] the allowance of these offsets." Joint Brief on Appeal, 8. DPCOA and DFFA maintain that the Unions had every reason to accept the city of Detroit's offer and no reason to reject it. Further, that the increase in final average compensation benefited the active union members and was in no way detrimental to the retired union members or the Retirement System. If the Retirement System became underfunded, the city of Detroit would have to increase its contribution to return it to fully funded status. The city of Detroit, on the other hand, simply maintains that defendants do not owe a fiduciary duty to plaintiff retirees in regard to negotiating collective bargaining agreements for active employees.

1 Plaintiff did not name the Retirement System in the complaint, but the Retirement System later intervened.

Because plaintiff had requested superintending control, the case was assigned to the chief judge of the circuit court. The chief judge, in a letter to the parties' attorneys, questioned whether the instant case was properly an action for superintending control. The parties submitted briefs on the issue and the chief judge determined that the instant case was not a case for superintending [*5] control and transferred it to another judge (hereafter the trial court). There was no appeal of that decision.

After the case had been transferred, the trial court granted plaintiff's motion to amend the complaint to include claims for breach of contract and conspiracy to interfere with a contract. The trial court dismissed count 1 of plaintiff's amended complaint seeking superintending control, and no appeal of that decision was taken. The contract claim was based on an October 2004 "memorandum of understanding" signed by representatives of plaintiff, the Unions and the city of Detroit, that reflected the parties' agreement that the Board should distribute Retirement System overfunding to plaintiff's members and the Unions' members. The Retirement System was not a member to this memorandum of understanding. Plaintiff alleged that defendants breached this memorandum of understanding because in fiscal year ending June 30, 2006 the Retirement System was overfunded by over $ 100 million, and the Unions and city of Detroit did not seek to distribute the overfunding to the active and retired members of the Unions. Rather, plaintiff claims that the Unions influenced its members seated on [*6] the Board to allow the city of Detroit an offset over the next three years (unless the Retirement System should become underfunded) in exchange for an increase in the Unions' active members' benefits. Plaintiff also alleges this arrangement constituted a conspiracy to breach the memorandum of understanding and a conspiracy to breach the Board's fiduciary duty to all its beneficiaries.

DPOA and the city of Detroit filed motions for summary disposition to address plaintiff's additional claims. They argued that the memorandum of understanding had been superseded by an April 2001 "release and settlement agreement to distribute certain retirement systems assets" entered into by the parties. In response, plaintiff claimed that the release did not apply to the fiscal year in question. DPOA and the city of Detroit also argued that plaintiff lacked standing because plaintiff's members (1) had not suffered a concrete injury in fact and that plaintiff's claims were based on speculation because plaintiff's members have not been denied any benefit from the Retirement System; (2) the city of Detroit and the Unions were required to negotiate active members' benefits as a "a mandatory subject of bargaining;" [*7] (3) the Unions and the city owed no legal duty to plaintiff; and (4) plaintiff's members were not entitled to an increased benefit merely because active Union members received a benefit. The remaining defendants subsequently filed motions for summary disposition essentially raising the same arguments. After a hearing, the trial court dismissed plaintiff's remaining claims because plaintiff failed to show that its members had been harmed because they had not been denied any benefit from the Retirement System, and therefore lacked standing.

II. STANDING

A. STANDARD OF REVIEW

Whether a party has standing is a question of law, which this Court reviews de novo. *Michigan Citizens for Water Conservation v Nestle Waters North America, Inc, 479 Mich 280, 291; 737 NW2d 447 (2007).*

B. ANALYSIS

Plaintiff argues that the trial court erred in determining that plaintiff lacked standing. Because plaintiff has no substantial legal interest in the overfunding of the Retirement System, we conclude that plaintiff lacked standing to bring the instant claims.

In *Lansing Sch Ed Ass'n v Lansing Bd of Ed*, Mich ; NW2d (Docket No. 138401, decided July 31, 2010), the Michigan Supreme Court recently overruled [*8] *Lee v Macomb Co Bd of Comm'rs, 464 Mich 726; 629 NW2d 900 (2001)*, under which, the "irreducible constitutional minimum" of standing contained three elements. Those elements were: (1) an invasion of a legally protected interest that is concrete and particularized and actual or imminent, not conjectural or hypothetical, (2) a causal connection between the injury and the conduct complained of such that the injury is fairly traceable to the conduct, and (3) likelihood and not merely speculation that the injury will be redressed by a favorable decision.

The *Lansing Sch Ed Ass'n* Court stated that, "Michigan standing jurisprudence should be restored to a limited, prudential approach that is consistent with Michigan's long-standing historical approach to standing." Slip op at 2. The *Lansing Sch Ed Ass'n* Court held that,

> a litigant has standing whenever there is a legal cause of action. Further, whenever a litigant meets the requirements of *MCR 2.605*, it is sufficient to establish standing to seek a declaratory judgment. Where a cause of action is not provided at law, then a court should, in its discretion, determine whether a litigant has standing. A litigant may have standing in this context [*9] if the litigant has a special injury or right, or substantial interest, that will be detrimentally affected in a manner different from the citizenry at large or if the statutory scheme implies that the Legislature intended to confer standing on the litigant.

Here, we conclude plaintiff did not establish a legal cause of action because plaintiff has no right to receive any overfunding from the Retirement System. *MCL 38.1140m* expressly provides that, "[i]n a plan year, any current service cost payment *may* be offset by a credit for amortization of accrued assets, if any, in excess of actuarial accrued liability." The word "may" designates discretion. *American Federation of State, County and Mun. Employees, AFL-CIO Michigan Council 25, 214 Mich App 182, 542 NW2d 333 (1995).* Thus, the decision to grant an offset to the employer if there is overfunding rests with the Board. Plaintiff cannot claim a right to the overfunding. Rather, plaintiff only has a right to receive the benefits due to its members. Plaintiff also maintains that the memorandum of understanding "was a binding contract between [p]laintiff, the Unions and the City [of Detroit]." However, the memorandum of understanding plainly [*10] states that "the parties believe that the Policemen and Firemen Retirement System is required to abide by the terms of the [m]emorandum of [u]nderstanding pursuant to applicable law *however the parties recognize the independence of the trust fund/Retirement System as a separate entity with fiduciary obligations.*" (Emphasis Added). The memorandum of understanding merely states the parties' aspirations in regard to whether the Board will distribute overfunding, if any, to all members of the Unions. Accordingly, plaintiff cannot establish a breach of contract on the basis of the memorandum of understanding.

Further, we cannot conclude that plaintiff "has a special injury or right, or substantial interest, that will be detrimentally affected in a manner different from the citizenry at large or if the statutory scheme implies that the Legislature intended to confer standing on the litigant." *Lansing Sch Ed Ass'n*, at slip op 22. There is no dispute that the statutory scheme does not provide plaintiff the right to challenge a decision in regard to the distribution of overfunding in the Retirement System. In this respect, the circumstances are akin to *Policemen and Firemen Retirement System, 270 Mich App 74.* [*11] In that case, the Retirement System was underfunded and the city of Detroit attempted to enforce a city ordinance to extend the amortization period to 20 years, contrary to the Board's decision to adopt a 14-year amortization period. This Court held that the "the statutory language is unequivocal that the Board determines the amount the employer (Detroit) contributes annually to the retirement system and that the employer, in turn, is "required" to make the contribution." *Id., at 80-81*. Further, that "[t]he Board's determination also necessarily includes the amount of time in which Detroit must pay the unfunded accrued pension liabilities because the period directly affects the amount Detroit must contribute to the plan each year." *Id., at 81*. Similarly, here, the Board determines the amount that the city of Detroit contributes (and conversely does not contribute) annually to the Retirement System. Given that the city of Detroit cannot challenge the Board's determination in regard to the amortization period during a period of underfunding, it follows that plaintiff has no legal basis to challenge an offset granted during a period of overfunding.

Further, plaintiff fails to establish [*12] that its members have a special injury or right, or substantial interest that will be detrimentally affected by the Board's decision to grant the city of Detroit an offset because the Retirement System was overfunded. Plaintiff alleges that "[p]laintiff's members suffered an injury in fact because the Defendants' actions reduced the security of the plan without providing a compensating benefit for the reduced security," Plaintiff's concerns are misplaced, however, given that "*Const 1963, art 9, § 24* provides that "[t]he accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby." Stated differently, plaintiff's action to recover any benefits owed lies in a contract against the city of Detroit. Plaintiff simply does not have an action against defendants.

Moreover, should any reduction of any benefit be realized, plaintiff has an action against the city of Detroit to recover any loss of benefit. Thus, although plaintiff may have standing to adjudicate an eventual claim in the event that its members are denied benefits, plaintiff's claim here [*13] is simply not ripe for adjudication. The requirement of ripeness precludes the adjudication of hypothetical or contingent claims. An action is not ripe if it rests on contingent future events. See *Hendee Putnam Tp, 486 Mich 556, 786 NW2d 521 (2010)*. Because plaintiff lacks standing to assert a cognizable legal claim, and otherwise has not stated a justiciable claim, we affirm the trial court's decision dismissing plaintiff's action.

/s/ William C. Whitbeck

/s/ Brian K. Zahra

/s/ Karen M. Fort Hood

E

BOARD OF TRUSTEES OF THE POLICEMEN/FIREMEN RETIREMENT SYSTEM OF THE CITY OF DETROIT, Plaintiff-Appellee, v CITY OF DETROIT, a municipal corporation; KWAME M. KILPATRICK, Mayor; SEAN K. WERDLOW, Chief Financial Officer/Finance Director; CLARENCE WILLIAMS, Treasurer, and CITY COUNCIL OF THE CITY OF DETROIT, Defendant-Appellants.

No. 253343, No. 260069

COURT OF APPEALS OF MICHIGAN

2005 Mich. App. LEXIS 1387

June 2, 2005, Decided

NOTICE: [*1] THIS IS AN UNPUBLISHED OPINION. IN ACCORDANCE WITH MICHIGAN COURT OF APPEALS RULES, UNPUBLISHED OPINIONS ARE NOT PRECEDENTIALLY BINDING UNDER THE RULES OF STARE DECISIS.

SUBSEQUENT HISTORY: Appeal denied by *Bd. of Trs. of the Policemen/Firemen Ret. Sys. v. City of Detroit, 2006 Mich. LEXIS 328 (Mich., Feb. 27, 2006)*

PRIOR HISTORY: Wayne Circuit Court. LC No. 03-321552-CK, LC No. 04-422445-CZ.

DISPOSITION: Affirmed.

JUDGES: Before: O'Connell, P.J., and Markey and Talbot, JJ.

OPINION

PER CURIAM.

In these consolidated appeals, defendants appeal by right the orders of the trial court granting plaintiff's motions for summary disposition. We affirm.

Plaintiff, the Board of Trustees of the Policemen/Firemen Retirement System of the City of Detroit, filed complaints against defendants after defendant city failed to make its annual contributions to the retirement system. Defendant city ultimately contributed $ 34,968,579.59 less to the retirement system than plaintiff had certified for fiscal year 2002-2003 and $ 9,788,774.86 less for fiscal year 2003-2004.

Defendants assert that the trial court erred in determining that *MCL 38.1140m* does not apply to the employer contributions made in 2003 and 2004. We disagree. A trial court's decision on a motion for summary disposition is reviewed de novo. *Dressel v Ameribank, 468 Mich. 557, 561;* [*2] *664 N.W.2d 151 (2003).* Summary disposition under *MCR 2.116(C)(10)* is appropriately granted if there was no genuine issue as to any material fact and the moving party was entitled to judgment as a matter of law. *Id.* The applicability of a statute is a question of law that this Court reviews de novo, *Fowler v Doan, 261 Mich. App. 595, 598; 683 N.W.2d 682 (2004)*, as is statutory interpretation, *Huggett v Dep't of Natural Resources, 464 Mich. 711, 717; 629 N.W.2d 915(2001).*

Defendants argue that *MCL 38.1140m*, effective December 30, 2002, applies prospectively to both contributions at issue because the contributions were *paid* in 2003 (for the 2002-2003 fiscal year) and 2004 (for the 2003-2004 fiscal year). However, the plain language of *MCL 38.1140m* provides the manner in which the governing board is to determine the employer contribution. Specifically, the statute mandates what an employer contribution must include, how an employer contribution amount is determined, and what action is required of the governing board and actuary [*3] in making this determination. The statute does not address when contributions are to be made. The statute thus provides that from its effective date forward, the employer contribution shall be determined in the manner described in the statute. Conversely, then, for determinations made before

December 30, 2002, defendant city's code provisions and city charter control and provide plaintiff with greater authority in determining the contribution (see *infra*).

Because in both Docket No. 253343 and Docket No. 260069 [1] the contribution rates at issue were apparently determined before the effective date of *MCL 38.1140m*, the statute does not apply to either contribution. That being the case, the applicable city code and charter provisions, which predate the effective date of the statute, govern how the contributions are to be determined and plaintiff's role and authority in making that determination.

1 A review of the record indicates that the actuary based his calculations on data as of June 30, 2002.

[*4] Defendants assert that under the city code and charter, plaintiff *must* fully credit funding contributions made to the now overfunded retirement plan. We disagree.

When interpreting a statute, the Legislature is presumed to have intended the meaning it plainly expressed. *Huggett, supra* at 717. If the plain and ordinary meaning of the language is clear, judicial construction is not usually necessary or permitted. *Id.*

Plaintiff board cites two specific provisions of defendant city's code, §§ 54-2-7 and 5443 -4, in support of its argument that defendant city must pay the contribution as set by plaintiff. The provisions provide:

> Sec. 54-2-7. Board of trustees to compute city's annual contribution.
>
> Based upon the provisions of this article, including any amendments, the *board of trustees shall compute* the city's annual contributions, *expressed as a percent* of active member compensations, to the retirement system for the fiscal year beginning July 1, 1975, using actuarial valuation data as of June 30, 1974, and for each subsequent fiscal year using actuarial valuation data as of the June 30th date which date is a year and a day before the first day [*5] of such fiscal year. The board shall report to the mayor and to the city council the contribution percents so computed, and *such contribution percents shall be used in determining the contribution* dollars to be appropriated by the city council and paid to the retirement system. For each fiscal year beginning July 1, 1975 and each fiscal year thereafter, *such contribution dollars shall be determined by multiplying the applicable contribution percent for wuch [sic] fiscal year by the member compensations paid for such fiscal year*; provided for the one fiscal year beginning July 1, 1975 and ending June 30, 1976 such member compensations so used shall not exceed 106.09 percent of the active members' annual compensations used in the actuarial valuation determining such contribution percent. [Emphasis added.]
>
> Sec. 54-43-4. Contributions to any payments from pension accumulation fund.
>
> Except as provided re the survivors benefit fund, the pension accumulation fund shall be the fund in which shall be accumulated reserves for the pensions and other benefits payable from contributions made by the city, and from which transfers shall be made as provided [*6] in this section. Contributions to and payments from the pension accumulation fund shall be made as follows:
>
> (a) Upon the basis of such assumptions as to future financial experiences as the board of trustees shall from time to time adopt, *the actuary shall annually compute the city's contribution, expressed as a percent of active member contributions,* to provide the pension reserves covering the pensions or other city-financed benefits to which members might be entitled or which might be payable at the time of their discontinuances of city employment; provided, such contribution percents shall not be less than amounts which, expressed as percents of active member compensations, will remain level from generation to generation of Detroit citizens. Upon the retirement or death of a member, the pension reserve for any benefits payable on his behalf shall be transferred from the pension accumulation fund to the pension reserve fund, to the extent of there being assets in the pension accumulation fund.

> (b) *The board of trustees shall annually ascertain and report to the mayor and the council the amount of contributions due the retirement system by the city, and* [*7] *the council shall appropriate and the city shall pay such contributions to the retirement system during the ensuing fiscal year.* When paid, such contributions shall be credited to the pension accumulation fund. [Emphasis added.]

The emphasized portions of the above code provisions clearly state that plaintiff board shall determine defendant city's contribution rate based on actuarial figures, communicate this percent figure to defendant city, that this percent figure "shall" be used in determining the dollar amount of the contribution after which the city council "shall" appropriate and the city "shall" pay such contributions. The word "shall" is generally used to designate a mandatory provision. *Old Kent Bank v Kal Kustom, Inc, 255 Mich. App. 524, 532; 660 N.W.2d 384 (2003).*

Defendants, however, assert that plaintiff's argument that the above provisions create a financial obligation renders the provisions in conflict with the 1997 city charter, which allows the city council discretion to appropriate and the mayor to spend funds. Defendants cite sections 8-203, 8-209, and 8-302 of the charter regarding defendant city's annual budget, budget adoption [*8] and limitations on obligations and payments for support of its argument concerning the city council's discretion to appropriate and, also, *City Council for the City of Detroit v Young, 449 Mich. 670; 537 N.W.2d 177 (1995)*, for the premise that the mayor can then spend less than the council appropriates. But, defendants' reliance on the charter sections cited above ignores article 11 of the city charter which specifically addresses the retirement plan. Section 11-101 states that the benefits provided by the plan, "being contractual obligations of the city, shall in no event be diminished or impaired." Section 11-102 incorporates by reference the retirement plan into the charter. Furthermore, while *Young, supra at 672*, concerns a mayor's cutting expenditures without the city council's prior approval, the mayor in that case did so by implementing a hiring freeze, reducing overtime, and delaying certain purchases, etc. It did not involve a scenario where a mayor refused to satisfy an already existing obligation. Defendants' argument fails to consider that defendant city is contractually obligated to fund the retirement system, and the code [*9] provisions, incorporated into the charter, provide that plaintiff board determine the appropriate contribution rate and requires defendant city to make the resulting dollar contribution. Here, the actuary provided the contribution rate which was calculated "using generally accepted actuarial principles and in accordance with standards of practice prescribed by the Actuarial Standards Board." [2]

> 2 December 26, 2002, cover sheet letter from Gabriel, Roeder, Smith & Company, Consultants & Actuaries.

Defendants further argue that the provisions plaintiff cites must be harmonized with the provision concerning annual interest and that this requires that the full funding credit be given when the plan is overfunded. The annual interest provision provides:

> Sec. 3. Annual interest.
>
> The Board of Trustees annually shall allow regular interest on the mean amount of assets in each of the funds for the preceding year. The amount so allowed shall be due and payable to said funds, and shall be annually credited [*10] thereto by the Board of Trustees from interest and other earnings on moneys of the system. Any additional amount, required to meet the regular interest on the funds of the System, shall be paid by the City and *any excess of earnings, over such amount required, shall be a portion of the amounts to be contributed by the city.* [Emphasis added.]

We agree with plaintiff's argument that this provision deals specifically with the treatment of annual interest in a given year and does not constitute a general requirement that a full funding credit be given when the system is overfunded. Furthermore, nothing in the record indicates why the plan is overfunded. Perhaps, for example, the plan earned excess interest in either of the years in question.

According to defendant city's code provisions and charter, plaintiff board determines the contribution rate based on actuarial data and reports. Nothing in the provisions mandates that plaintiff board give defendant city a full funding credit, any such credit appears to be clearly a matter of discretion. Indeed, it appears that the charter incorporates the language of *Const 1963, art 9, § 24*, which reflects a concern that the retirement [*11] system be properly funded. Therefore, under defendant city's code provisions and city charter, it is plaintiff board that has discretion regarding any credit, not defendants. [3]

3 We note, however, this discretion is limited following the enactment of *MCL 38.1140m*, effective December 30, 2002. This statute will apply to future employer contribution rates, and, pursuant to the statute, plaintiff must act in accordance with the actuary's recommendation.

We affirm.

/s/ Peter D. O'Connell

/s/ Jane E. Markey

/s/ Michael J. Talbot

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Only the Westlaw citation is currently available.

California Rules of Court, rule 8.1115, restricts citation of unpublished opinions in California courts.

Court of Appeal,
Fifth District, California.

Michael R. O'NEAL et al., Plaintiffs and Appellants,
v.
STANISLAUS COUNTY EMPLOYEES' RETIREMENT ASSOCIATION, Defendant and Respondent.

F061439 | Filed April 4, 2012

APPEAL from a judgment of the Superior Court of Stanislaus County. Roger T. Picquet, Judge. (Retired Judge of the San Luis Obispo Sup. Ct. assigned by the Chief Justice pursuant to art. VI, § 6 of the Cal. Const.) (Super. Ct. No. 648469)

Attorneys and Law Firms

Law Office of Michael A. Conger and Michael A. Conger; Richard H. Benes for Plaintiffs and Appellants.

Reed Smith, Harvey L. Leiderman and Jeffrey R. Rieger for Defendant and Respondent.

Opinion

OPINION

DETJEN, J.

***1** This is an appeal from a judgment dismissing an amended complaint for damages and for declaratory and injunctive relief against a county employees' retirement association. The case involves actions taken by a county retirement association in transferring funds from a supplemental benefits account to the general trust fund and in establishing a schedule for the county's payment of unfunded liabilities of the retirement plan. We conclude the trial court erred in sustaining respondent's demurrer to appellants' complaint and, thereafter, in granting judgment when appellants declined to further amend their complaint. In summary, we conclude appellants have standing to seek declaratory and injunctive relief and have adequately pled causes of action for such relief. At the demurrer stage, of course, there is no way to know whether appellants ultimately will prevail, but we conclude the demurrer should have been overruled. Accordingly, we reverse the judgment.

I. FACTS AND PROCEDURAL HISTORY

Appellants Michael R. O'Neal, Rhonda Biesemeier, and Dennis J. Nasrawi are former Stanislaus County employees; each is a member of respondent Stanislaus County Employees' Retirement Association with vested pension rights. (Because appellants appeal from the trial court's sustaining of a demurrer, we take the well-pleaded facts stated in the complaint as true. (*Beal Bank, SSB v. Arter & Hadden, LLP* (2007) 42 Cal.4th 503, 505, fn. 1.) The following summary reflects that standard. In addition, we grant the parties' requests that we take judicial notice of certain facts, as further described in the footnote.[1])

A. *Statutory background.*

***2** Respondent was formed and operates under the provisions of the County Employees Retirement Law of 1937 (CERL), Government Code section 31450 et seq.[2] (Counties are not required to, and many have not, established their retirement plans under CERL. (See *In re Retirement Cases* (2003) 110 Cal.App.4th 426, 433.)) "Under CERL an employee's pension is a combination of a retirement annuity based on the employee's accumulated contributions supplemented by a pension established with county contributions sufficient to equal a specified fraction of the employee's 'final compensation.' [Citations.]" (*Ventura County Deputy Sheriffs' Assn. v. Board of Retirement* (1997) 16 Cal.4th 483, 490.)[3] Retirement benefits "are funded by employer contributions, employee contributions, and investment earnings on monies deposited in the fund." (79 Ops.Cal.Atty.Gen. 95, 96 (1996).)

The persons who may qualify as annuitants or beneficiaries under the retirement system of a CERL county constitute that county's retirement association. (§ 31474.) The association is governed by a board, usually (and apparently is in this case) called the Board of Retirement (hereafter, the board or the retirement board). (See § 31459, subd. (c).)[4] The board is required to recommend to the county's board of supervisors a rate of contribution by employees and by the county as employer, at regular intervals, after considering past and expected experience of the association in paying benefits. (See § 31453, subd. (a).) The board of supervisors is then required to establish an appropriation to pay the county's contribution to the pension fund. (§§ 31581, 31584.)

The retirement board's establishment of a contribution rate is to be based on the valuation of the "assets and liabilities of the retirement fund."(§ 31453, subd. (a).) This valuation "shall be conducted under the supervision of an actuary""at intervals not to exceed three years." (*Ibid.*) The valuation "shall cover the mortality, service, and compensation experience of the members and beneficiaries, and shall evaluate the assets and liabilities of the retirement fund." (*Ibid.*) The retirement board uses these actuarial evaluations of the system, as modified over time, to establish the county's annual pension contribution rate, which is then funded by the county's board of supervisors.[5] (See § 31584.)

In determining the county's contribution rate, a board of retirement may adopt, and respondent has adopted, a statutory "normal contribution rate." That normal rate "shall be computed as a level percentage of compensation which, when applied to the future compensation of the average new member entering the system, together with the required member contributions, will be sufficient to provide for the payment of all prospective benefits of such member."(§ 31453.5.) To the extent the normal rate does not cover the total liability determined by the actuaries, the board must recommend an additional assessment that will amortize "[t]he portion of liability not provided by the normal contribution rate ... over a period not to exceed 30 years." (*Ibid.*)

*3 As noted, one source of funds for the payment of retirement benefits is the income from investment of previous contributions to the retirement fund. When the board of retirement determines the liabilities and assets of the fund, it (guided by its actuary) makes certain assumptions about liabilities (including the age and final compensation of employees when they retire) and assets (including the interest or rate of return on existing assets as a source of funds to pay benefits). If the investment earnings during a particular year exceed the amount credited by the board to contributions and reserves for that year, these excess earnings "shall remain in the fund as a reserve against deficiencies in interest earnings in other years, losses on investments, and other contingencies, except that, when such surplus exceeds 1 percent of the total assets of the retirement system, the board may transfer all, or any part, of such surplus in excess of 1 percent ... for the sole purpose of payment of the cost of the benefits described in this chapter."(§ 31592.2.) Among the "benefits described in this chapter" for which excess earnings may be used is the payment of "all, or a portion, of the premiums, dues, or other charges for health benefits" for retirees. (*Ibid.*) Retirees have no vested interest in the payment of these supplemental benefits, which are provided at the option of the county. (70 Ops.Cal.Atty.Gen. 1, 4 (1987).) In previous years, respondent accrued such excess earnings and transferred certain of those earnings in excess of required reserves to an account it called a non-valuation reserve. As explained in respondent's brief on appeal "the system's actuaries did not count those assets against its pension liabilities when determining the system's long term pension funding needs; hence the designation, 'non-valuation.' " A primary focus of the amended complaint is respondent's use of these non-valuation reserves for other purposes, which we will describe in the next sections.

B. *Allegations concerning respondent's actions.*

At some point after the June 30, 2006, valuation of respondent's assets and liabilities, respondent determined that its actuaries had erred and had underestimated the association's liabilities by approximately $40 million. (The complaint alleges the shortfall as "in excess of $40 million." The actuary report estimates the shortfall as "nearly $38 million.") In addition, the value of the association's investment assets apparently decreased during the economic upheavals of 2007 into 2009. The amended complaint appears to allege (and our understanding of the allegation is augmented by the actuary report) that as a result of these two factors and certain other changes in actuarial assumptions, the pension fund was "underfunded by $595.6 million" as of June 30, 2009.

The amended complaint alleges that, confronted with this "dramatic[ ] plunge [ ]" in the "health of the pension trust fund," the association "imprudently and by the artifice of various actuarial schemes, manipulated the pension trust fund it administers in order to *reduce* County employer contributions by [ ] at least $81.4 million, rather than to assure the competency of the assets of the plan."[6] The amended complaint alleges four specific actions taken by respondent as the basis for the complaint's four causes of action, which we now describe.

C. *The amended complaint and the demurrer.*

The first cause of action of the amended complaint alleges that on April 28, 2009, respondent "transferred $10 million from a non-valuation reserve of pension trust funds to be used as the County's employer contribution from the County for fiscal year 2009–2010." In addition, that cause of action alleges the pension fund lost and will continue to lose the income from the $10 million that should have been contributed by the county "until that skipped $10 million employer contribution ... is paid." It alleges the $10 million transfer "was a breach of [respondent's] constitutional, fiduciary duties to the plaintiffs under section 17 of article 16 of the California Constitution." Further, it alleges that appellants "have been deprived pension benefits" by respondent's actions. Although the nature of such benefits is not directly stated, the parties and the trial court inferred that the allegation intended to address the loss of the supplemental benefits, such as payment for medical insurance, that previously had been paid from the non-valuation assets.

The second cause of action alleges that, also on April 28, 2009, respondent separately acted to "transfer ... from non-valuation reserves to valuation reserves in order to reduce the County's employer contribution for 2009–2010" a further $50 million. The second cause of action alleges similar loss of investment income, breach of fiduciary duty, and deprivation of supplemental benefits as a result of the removal from non-valuation reserves of the $50 million.

*4 For purposes of narrative continuity, we now skip to the fourth cause of action in the amended complaint. That cause of action alleges that on June 9, 2010, several months after this action was filed, respondent "transferred another $21.4 million ... from a non-valuation reserve of pension trust funds to be used as the County's employer contribution from the County for fiscal year 2010–2011." The fourth cause of action alleges similar loss of investment income, breach of fiduciary duty, and deprivation of supplemental benefits as a result of the payment of the employer contribution from non-valuation reserves.

The third cause of action addresses a different kind of action by respondent. That cause of action alleges that respondent violated its fiduciary duty and its duty under section 31453.5 by requiring an employer contribution that failed to amortize the retirement plan's unfunded liability within 30 years. This allegation is further explained by the actuary report (and the parties agree with this expanded explanation in their briefs on appeal), as follows: At some point after June 30, 2008, the retirement board made two changes in its existing policy for the recovery of unfunded liability through the county's employer contributions. First, the board extended the period during which the unfunded liability would be amortized from 20 to 30 years. (See § 31453.5 ["The portion of liability not provided by the normal contribution rate shall be amortized over a period not to exceed 30 years."].) In addition, the board changed the calculation of the amortization amount from a level-amount amortization to the same percentage-of-pay calculation permitted for the "normal" contribution under section 31453.5. Because of this second change, the amount of the county's contribution would be expected to increase over time as a result of the increase in the county's total payroll for active employees. As a result of this "back loaded" payment schedule stretched over 30 years, the county's current contribution was reduced, according to the actuary report, by 4.73 percent of annual payroll, from 17.47 percent of payroll to 12.74 percent of payroll—a reduction of $11.5 million in the county's contribution in the first year of the new policy. As further described in the actuary report: "Because of this change, the projected rate of recovery in the funding level will be significantly curtailed: Under current projections with continued 30–year level percentage of pay amortization, the funding ratio is expected to be 10% lower at the end of ten years than it would be under the old amortization policy. With a level percentage of pay amortization policy and a period of 17 or more years, the amortization payment in the current year will be less than the interest on the unfunded amount—no payment towards 'principal' is made." The third cause of action alleges that this failure to amortize the unfunded liability—that is, "[t]o liquidate (a debt) by installment payments or payment into a sinking fund" (American Heritage Dict. (3d college ed. 2000) p. 45)—in violation of section 31453.5 reduces the funded ratio of the pension fund below the level at which respondent is permitted to pay for supplemental benefits.

In addition to seeking injunctive relief to prevent future acts in violation of respondent's fiduciary duty and to require respondent to assess against the county a proper employer contribution, each cause of action seeks "damages" from respondent "(paid by available insurance coverage)."

Respondent filed a general demurrer to the amended complaint. It contended the amended complaint failed to allege facts sufficient to constitute a cause of action. In particular, respondent contended the complaint attacked discretionary acts of respondent but failed to allege an abuse of discretion; that it failed to allege legally cognizable damages; that respondent was immune from damages claims for discretionary acts; and that the complaint failed to allege a basis for injunctive relief.

D. *Proceedings in the trial court.*

*5 After a hearing on the demurrer, the trial court sustained the demurrer. The court concluded the amended complaint "does not allege facts which if true would show any abuse of discretion" by respondent. The court further determined that the complaint failed to allege legally cognizable damages: The mere reduction in value of the pension fund does not constitute cognizable injury, nor does the loss of discretionary supplemental benefits to which appellants do not have a vested right. In addition, the court determined appellants had not alleged a right to injunctive relief because the past acts alleged in the complaint were not alleged to be an abuse of discretion, so future repetitions of such acts were not wrongful. Finally, the court concluded respondent's immunity claim was moot, since the amended complaint "fails to adequately seek legally cognizable damages." The court permitted appellants to further amend the complaint as to some of these defects, but not others. Appellants elected not to further amend the complaint and the court entered judgment dismissing the action with prejudice.

II. DISCUSSION

We review a judgment entered on a demurrer de novo to determine whether the well-pleaded facts in the complaint state a cause of action. (See *Blank v. Kirwan* (1985) 39 Cal.3d 311, 318; *Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 Cal.App.4th 1020, 1034–1035.)

Many of the specific powers and duties of a county board of retirement are set forth in CERL. (See, e.g., § I(A), *ante*.) Underlying those statutory provisions are the requirements of article XVI, section 17 of the California Constitution (hereafter, section 17), which addresses the powers and duties of the governing boards of all "public pension or retirement system[s]." "Retirement board trustees are fiduciaries (Cal. Const., art. XVI, § 17) and as such are subject to suit for breach of fiduciary duty when their decisions fall short of the standard the law demands." (*Lexin v. Superior Court* (2010) 47 Cal.4th 1050, 1102 (dicta)[7].)

Section 17 contains the following provisions that are relevant to the present appeal: "The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system." (*Id.,* subd. (a).) "The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty." (*Id.,* subd. (b).) These are "fiduciary responsibilities." (*Id.,* subd. (e).) "The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims." (*Id.,* subd. (c).)

The amended complaint alleges, and respondent does not dispute, that appellants, as members of the retirement system, are beneficiaries of a trust, administered by respondent and by the retirement board as trustees. The "beneficiary of a trust can maintain a suit (a) to compel the trustee to perform his duties as trustee; (b) to enjoin the trustee from committing a breach of trust; [and] (c) to compel the trustee to redress a breach of trust...." (Rest.2d Trusts, § 199 [paragraph breaks omitted]; see *Triplett v. Williams* (1969) 269 Cal.App.2d 135, 138.)

*6 Three somewhat related conclusions follow from these initial principles. First, injury to the trust corpus, and violation of fiduciary duties resulting in such injury, causes sufficient harm to the beneficiary to support an equitable action to remediate the breaches of the fiduciary duty. Indeed, if a beneficiary with knowledge of the trustee's breach of fiduciary duty does not seek judicial relief, the beneficiary may be guilty of laches, precluding such equitable relief. (See Rest.2d Trusts, § 219; *id.,* com. a, p. 512; cf. *Triplett v. Williams, supra,* 269 Cal.App.2d at p. 138.) Accordingly, the fact that appellants do not allege that respondent's acts have resulted in immediate loss of vested benefits is not a sufficient basis to sustain the demurrer. (See *Harnedy v. Whitty* (2003) 110 Cal.App.4th 1333, 1339–1342; cf. *Board of Administration v. Wilson* (1997) 52 Cal.App.4th 1109, 1125 [mandate proceedings].) Appellants have alleged that respondent has statutory and constitutional fiduciary duties both to administer the trust assets solely for the benefit of the members and to obtain contributions to amortize unfunded liability in a timely manner. While appellants still must prove these allegations, and there may be defenses available to respondent (see *Bandt v. Board of Retirement* (2006) 136 Cal.App.4th 140, 159), appellants' allegations are sufficient to defeat the demurrer to the extent it was based upon appellants' failure to allege cognizable damages.[8]

*7 Second, appellants have alleged cognizable, immediate harm resulting from the alleged breaches of fiduciary duty. The complaint alleges, in effect, that respondent (through its governing retirement board) took funds that had been set aside to provide discretionary supplemental retirement benefits, including health insurance benefits, and used those funds for a different and impermissible purpose, namely, to lower the county's employer contribution for the years in question. It is true, as the trial court concluded and respondent argues on appeal, that appellants and other retired members do not have a vested right to supplemental retirement benefits. Respondent's board has discretion to discontinue those benefits—and would be required to do so if respondent did not have sufficient excess earnings to fund the supplemental benefits. (See § 31592.2.) Nevertheless, any exercise of discretion that results in termination of those supplemental benefits "must be measured against the general rules of law and, in the case of a statutory grant of discretion, against the specific law that grants the discretion." (*Horsford v. Board of Trustees of California State University* (2005) 132 Cal.App.4th 359, 393.) "The scope of discretion always resides in the particular law being applied, i.e., in the 'legal principles governing the subject of [the] action....' Action that transgresses the confines of the applicable principles of law is outside the scope of discretion and we call such action an 'abuse' of discretion." (*City of Sacramento v. Drew* (1989) 207 Cal.App.3d 1287, 1297.)[9]

In this case, the discretion vested in respondent must always be exercised "solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty."(§ 17, subd. (b).) Thus, while there may be good reasons for termination of supplemental retirement benefits, and while termination of the benefits is within the statutory discretion of respondent's board, the exercise of that discretion is measured not against the retirees' *contractual* right to such benefits, but against the constitutional duty of the board to act at all times for the benefit of its members. Accordingly, the allegation in the amended complaint that respondent breached its fiduciary duty is, in the circumstances of this case, the legal equivalent of an allegation that respondent's actions were a breach of discretion, since respondent's board does not have lawful discretion to act in contravention of its constitutional duties. (See *City of Sacramento v. Public Employees Retirement System* (1991) 229 Cal.App.3d 1470, 1494.) Thus, the allegations in the amended complaint that respondent breached its fiduciary duty to appellants in causing the termination of discretionary benefits sufficiently alleges a breach of duty causing legal injury to appellants and is sufficient to withstand respondent's demurrer.

Third, because the amended complaint adequately alleges wrongful acts by respondent both before and after commencement of this action, and because it alleges the harmful effects of those actions will continue until and unless respondent takes corrective action, the amended complaint adequately alleges the grounds for declaratory and injunctive relief. (See *Katzberg v. Regents of University of California* (2002) 29 Cal.4th 300, 307.) In the case of alleged breaches of fiduciary duties by trustees, as previously stated, such injunctive relief may not only prohibit future breaches of fiduciary duty but may also require the trustee to act to remediate previous breaches of fiduciary duty. (See Rest.2d Trusts, § 199.)

*8 As a result of these conclusions, we further conclude that the trial court erred in sustaining respondent's demurrer to the amended complaint to the extent it determined appellants failed to state causes of action for injunctive relief.

The trial court did not rule on the issue of respondent's immunity from damages arising from exercise of discretionary duties. (See §§ 815.2, subd. (b), 820.2.) We do not reach this issue on appeal from a judgment on a sustained demurrer: Where the complaint states a cause of action, as does the present complaint with respect to declaratory and injunctive relief, a demurrer will not lie to challenge a claim for alternative or additional relief, such as damages. (See *Kong v. City of Hawaiian Gardens Redevelopment Agency* (2002) 108 Cal.App.4th 1028, 1047.) In addition, it seems likely that, if appellants are successful on the merits, respondent has ample authority under CERL to correct its actions, through establishment of additional employer contributions or other injunctive relief the court may grant, thereby obviating a claim for damages.

Finally, we briefly address appellants' contention that we should order the removal of the trial judge in this case because in some manner he shares the same financial interest in the action that resulted in his assignment to the case in the first place. After notice to the parties, we take judicial notice of the order of the Chief Justice of California assigning the Honorable Roger T. Picquet, Retired Judge of the Superior Court of the State of California for the County of San Luis Obispo for all purposes in Stanislaus County Superior Court case No. 648469. In addition, we take notice of the "assignment request worksheet" (full capitalization omitted), which indicates assignment of an out-of-county judge was required under Code of Civil Procedure section 170.8 because of a "[f]ull bench recusal." Appellants contend they and their counsel did not become aware until after judgment was entered that there may be grounds upon which they might wish to seek recusal of Judge Picquet. Because the matter was not raised in the trial court, and because of the limited record before us concerning both the timeliness and the grounds for the request for recusal, we deny appellants' request without prejudice to appellants' renewal of this request in the trial court, and without prejudice to respondent's objection to the timeliness and grounds for such recusal.

The judgment is reversed. The matter is remanded for entry of a new order overruling the demurrer to the first amended complaint filed June 11, 2010. Appellants' requests for judicial notice are granted; respondent's request for judicial notice is granted in part and denied in part, as set forth in footnote 1, *ante.* Appellants are awarded costs on appeal.

WE CONCUR:

CORNELL, Acting P.J.

GOMES, J.

DISPOSITION

Footnotes

1 The parties have filed three separate requests for judicial notice. We deferred consideration of each request pending consideration of the appeal on its merits.

Two of the requests for judicial notice were filed by appellants and were not opposed by respondent. We grant those requests in full. Accordingly, we take judicial notice of a letter dated March 15, 2011, from the Executive Officer for the Superior Court of California, County of Stanislaus, to the Retirement Board of the Stanislaus County Employees' Retirement Association, available at <http://www.stancera.org/files/2011_ Agendas_and_Minutes/20110322_AGN_Item9b_OCR.pdf> (viewed January 25, 2012.) In addition, we take judicial notice of November 1992 California Ballot Pamphlet, pages 36–39, which concern Proposition 162, "Public Employees' Retirement Systems. Initiative Constitutional Amendment." We also take judicial notice of the "true signification" in the English language of the word "amortization." (see Evid.Code, § 451, subd. (e) [judicial notice shall be taken of "true signification of all English words and phrases and of all legal expressions"].)

Respondent has requested that we take judicial notice of a document entitled "Stanislaus County Employees' Retirement Association Actuarial Review and Analysis as of June 30, 2008, Final Report May 12, 2009," prepared by EFI Actuaries (hereafter referred to as the actuary report). The trial court denied respondent's request to take judicial notice of the 75–page actuary report, and we agree with its bases for denying the request. Nevertheless, the actuary report contains a fuller explanation of certain actions of respondent's governing board (and some of the circumstances giving rise to those actions) than is set forth when those actions and circumstances are alleged in the amended complaint. While appellants have filed an opposition to the request that we take judicial notice of the actuary report, the parties' briefs clearly agree upon certain of the expanded explanations contained in the report. For the purposes of this appeal, and in light of the standard of review on appeal after an order sustaining a demurrer, we deem these additional facts to be judicially noticed as "not reasonably subject to dispute and [ ] capable of immediate and accurate determination by resort to sources of reasonably indisputable accuracy." (Evid.Code, § 452, subd. (h).) In addition, to the extent the trial court sustained the demurrer without leave to amend, the reviewing court must determine whether there is a reasonable probability that the complaint could be amended to state a cause of action. (*Williams v. Housing Authority of Los Angeles* (2004) 121 Cal.App.4th 708, 719.) The actuary report provides a basis for such amendment. As with the facts actually alleged in the amended complaint, the legal and actuarial significance of any matter drawn from the actuary report may be disputed at trial, even though we have accepted those facts in this appeal.

We reject, however, respondent's request for judicial notice of the actuary report to the extent that respondent asserts that the report's certification that the "valuation was performed in accordance with generally accepted actuarial principles and practices" constitutes an endorsement of respondent's action in adopting changes to its "amortization policy for the Plan's unfunded liability." While the parties agree concerning the actuaries' *description* of the changes to the amortization policy (and we therefore judicially notice that description), the certification does not, by its terms, purport to approve or disapprove of the policy itself, whether on the basis of actuarial or other considerations, and we do not deem the actuary report to establish any basis for judicially noticing that the report's authors either approved or disapproved of the changed amortization policy.

2 All further section references are to the Government Code, except as otherwise noted.

3 In addition to the county employees' pension plan, the association also administers pension plans for the Superior Court of Stanislaus County, one city and five special districts located in Stanislaus County. Those other plans are not involved in the present appeal.

4 The retirement board is not named separately as a party in this action, and all actions taken by the retirement board are alleged in the amended complaint as having been taken by "StanCERA," an acronym for Stanislaus County Employees' Retirement Association.

5 For purposes of illustration, we note that CERL provides that at the inception of a new county retirement system, and until the commencement of valuations pursuant to section 31453, the contribution rate "shall equal 23.77 percent of the total compensation provided for all safety members" and "8.85 percent of the total compensation provided for all other employees who are members of the retirement association."(§ 31581.) ("Safety members" comprises active law enforcement and fire suppression personnel, as well as certain other employees. (See § 31469.3.))

6 California Constitution, article XVI, section 17, subdivision (e) states: "The retirement board of a public pension or retirement system, consistent with the exclusive fiduciary responsibilities vested in it, shall have the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system."

7 The pension fund is not, however, a "trust" for purposes of the Probate Code. (See Prob.Code, § 82, subd. (b)(13) [excluding trusts "for the primary purpose of paying ... pensions[ ] or employee benefits of any kind"].)

8 In *Bandt v. Board of Retirement, supra,* 136 Cal.App.4th 140, San Diego County had issued certain bonds that generated $550 million, which the county voluntarily contributed to the employees' pension fund. (*Id.* at p. 144.) The board of retirement conducted an interim valuation of its assets reflecting this voluntary contribution. (*Ibid.*) Appellants, current retirees of the system, sought declaratory and mandamus relief, contending that the interim valuation reduced the county's required contribution for the next fiscal year. They contended "the Board was constitutionally required under section 17 to maximize the amount of money in the pension fund in the short run by refusing to conduct an interim valuation that would take into account the $550 million payment." (*Id.* at p. 145.) In affirming a judgment in the retirement board's favor, after a trial on the merits, the appellate court noted that the board's action did not reduce any benefit to the appellants and did not materially diminish the fund's security for payment of future benefits. (*Id.* at pp. 157–158.) To the contrary, the board's action could have encouraged future voluntary payments by the county and, by reducing the county's mandatory contribution, "stav[e] off [ ] possible job losses" among current county employees. (*Id.* at p. 159.)

By contrast, in the procedural posture of the present case, potential defenses of respondent under the so-called "business judgment" rule or otherwise (see *Bandt v. Board of Retirement, supra,* 136 Cal.App.4th at p. 156) are not before the court. We do observe, however, that use of funds *already in the retirement trust fund* to reduce current obligations of the county employer presents significantly different questions than does merely crediting the county employer for a voluntary contribution of *new funds.* (See 79 Ops.Cal.Atty.Gen., *supra,* at pp. 99–101 [use of excess earnings to reduce current county employer contribution violates CERL]; Ballot Pamp., Gen. Elec. (Nov. 3, 1992) text of Prop. 162, § 3, subd. (d), p. 70 ["assets of public pension systems are [to be] used exclusively for the purpose of efficiently and promptly providing benefits and services to participants of these systems, and not for other purposes"].) Nevertheless, there are doubtless difficult discretionary decisions a retirement board must make in the context of the discharge of its constitutional fiduciary duty and "there is nothing in section 17, subdivision (b) that would require that the Board act in a manner consistent with the principle of intergenerational equity" (*Bandt v. Board of Retirement, supra,* 136 Cal.App.4th at p. 160) as it balances the interests of active and retired members.

One further point is worth making. There may well be a difference under CERL between a retirement board's use of excess earnings "as a reserve against deficiencies in interest earnings in other years, losses on investments, and other contingencies" (§ 31592.2) and use of those funds to pay (or reduce) the county's employer contribution. A retirement board's actions in using the reserve to pay retirement benefits would indirectly affect the amount assessed for the rate of employer contributions "necessary to fund the system in the future." (79 Ops.Cal.Atty.Gen., *supra,* at p. 101.) Similarly, a retirement board's actions in using the reserve to make up losses on investments from its current assets would indirectly affect the amount assessed for employer contributions for unfunded losses. The complaint alleges, however, that respondent used the reserve funds not to offset losses, but to directly reduce the employer's contribution in the years in question. In addition, any exercise of discretion to apply reserves to such losses in a particular instance would be subject to review under the standards of section 17, subdivision (b), to the extent it was properly alleged that the transfer was not in the interest and for the benefit of the members of the association.

9 Respondent contends *Claypool v. Wilson* (1992) 4 Cal.App.4th 646 approved the use of reserve assets to pay the public employer's contribution to a pension fund. The petitioners in *Claypool,* however, challenged the constitutionality of statutes enacted by the Legislature, not (as in this case) the actions of the trustees of a public pension. (*Id.* at p. 652.) The court in *Claypool* found the trust provisions of subdivision (b) of section 17, pertained to "the duties of the fiduciary of the public pension or retirement system," but did not apply to the duties of the Legislature. (*Claypool v. Wilson, supra,* 4 Cal.App.4th at p. 673, fn. 9.) Also, unlike *Claypool,* this case post-dates the voters' adoption of Proposition 162 in November 1992, which added the constitutional requirement in section 17, subdivision (b), that a retirement board's duty to its members and their beneficiaries "shall take precedence over any

other duty."

End of Document

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Peek v. Comm'r

United States Tax Court
May 9, 2013, Filed
Docket Nos. 5951-11, 6481-11.

Reporter: 2013 U.S. Tax Ct. LEXIS 13; 140 T.C. No. 12

LAWRENCE F. PEEK AND SARA L. PEEK, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent;DARRELL G. FLECK AND KIMBERLY J. FLECK, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Disposition: Decisions will be entered under Rule 155.

Case Summary

Procedural Posture

After respondent IRS determined tax deficiencies and imposed IRC § 6662 penalties in connection with petitioner taxpayers' exclusion, from their income, of certain gains realized on account of the sale, by petitioners' Roth IRAs, of stock in Newco, a company they formed, petitioners sought review. At issue was whether petitioners' personal guaranties were prohibited transactions per IRC § 4975(c)(1)(B) and whether penalties were properly imposed.

Overview

Using a strategy created by CPA, petitioners established self-directed IRAs, transferred funds from existing plans into the IRAs and directed the IRAs to purchase all of the stock of Newco, an entity they formed. Using that cash and proceeds from loans, including loans from Target's sellers, Newco then purchased all of the assets of Target. Petitioners executed personal loan guaranties. When petitioners later sold the now-significantly appreciated Newco stock, they treated the gain as deferred based on the existence of IRAs. The IRS determined deficiencies on the theory that the loan guaranties were prohibited transactions per § 4975, that the accounts thus had ceased to be IRAs on the date of the guaranties, and that the gain thus was currently taxable. On review, the court agreed. First, § 4975(c)(1)(B) prohibited petitioners from making loans or loan guaranties either directly to their IRAs or indirectly to their IRAs by way of Newco. Second, each guaranty constituted a continuing prohibited transaction preventing either account from being an IRA at any time after the original guaranties were made. Last, petitioners failed to establish grounds for relief from the penalties.

Outcome

The court held that the guaranties constituted indirect extensions of credit to the IRAs and were prohibited transactions by reason of which the accounts ceased to be IRAs and that the gains realized on the sale of the stock was includable in petitioners' taxable income. It also held that the § 6662 penalties were properly imposed.

Syllabus

In 2001 Ps established traditional IRAs. Ps formed FP Corp. and directed their new IRAs to use rolled-over cash to purchase 100% of FP Corp.'s newly issued stock. Ps used FP Corp. to acquire the assets of AFS Corp. Ps personally guaranteed loans of FP Corp. that arose out of the asset purchase. In 2003 and 2004 Ps undertook to roll over the FP Corp. stock from their traditional IRAs to Roth IRAs, including in Ps' income the value of the stock rolled over in those years. In 2006 after the FP Corp. stock had significantly appreciated in value, Ps directed their Roth IRAs to sell all of the FP stock. Ps' personal guaranties on the loans of FP Corp. persisted up to the stock sale in 2006. R contends that Ps' personal guaranties of the FP Corp. loan were prohibited transactions, and, as a result, the gains realized in 2006 and 2007 from the 2006 sales of FP stock should be included in Ps' income.

Held: Each of Ps' personal guaranties of the FP Corp. loan was an indirect extension of credit to the IRAs, which is a prohibited transaction; and under I.R.C. sec. 408(e), the accounts that held the FP Corp. stock ceased to be IRAs.

Held, further, the gains realized on the sale of the FP Corp. stock are included in Ps' income.

Held, further, Ps are liable for the accuracy-related penalty under I.R.C. sec. 6662.

Counsel: Sheldon Harold Smith, for petitioners.

Shawn P. Nowlan, E. Abigail Raines, and John Q. Walsh, Jr., for respondent.

Judges: GUSTAFSON, Judge.

Opinion by: GUSTAFSON

Opinion

[*P2] GUSTAFSON, Judge: Pursuant to section 6212,[1] the Internal Revenue Service ("IRS") issued statutory notices of deficiency to petitioners Lawrence F. Peek and Sara L. Peek on December 9, 2010, and to petitioners Darrell G. Fleck and Kimberly J. Fleck on December 14, 2010, determining the following deficiencies in income tax and accuracy-related penalties under section 6662(a) for tax years 2006 and 2007: [*P3]

Taxpayers	Year	Deficiency	Penalty sec. 6662(a)
Peek	2006	$223,650	$44,730.00
	2007	1,399	279.80
Fleck	2006	243,229	48,645.80
	2007	4,948	989.60

The issues for decision in these consolidated cases are: (i) whether Mr. Fleck's and Mr. Peek's personal guaranties of a loan to FP Company were prohibited transactions under section 4975(c)(1)(B);[2] and (ii) whether the Flecks and the Peeks owe accuracy-related penalties under section 6662(a).

[*P4] FINDINGS OF FACT

These cases were submitted by the parties fully stipulated under Rule 122 for decision without trial,[3] and the stipulated facts are incorporated herein by this reference.

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code (26 U.S.C.), and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Because we hold that the loan guaranties were prohibited transactions, we need not and do not reach the additional questions of whether prohibited transactions occurred (i) when FP Company made payments of wages to Mr. Fleck and Mr. Peek (which the IRS contends were prohibited transactions under section 4975(c)(1)(D)), or (ii) when FP Company made payments of rent to an entity owned by Mrs. Fleck and Mrs. Peek (which the IRS contends were prohibited transactions under section 4975(c)(1)(E)). (We also need not consider whether those issues constitute "new matter". See note 3 below.) Furthermore, because our holding that the loan guaranties were prohibited transactions resolves the income tax issues in favor of the IRS and against the petitioners, we need not reach the question whether Mr. Fleck and Mr. Peek would, in the alternative, owe excise tax for excess contributions to their successor IRAs under section 4973.

[3] *HN1* The burden of proof is generally on the taxpayer, see Rule 142(a)(1), and the submission of a case as fully stipulated under Rule 122 does not alter that burden, see Borchers v. Commissioner, 95 T.C. 82, 91 (1990), aff'd, 943 F.2d 22 (8th Cir. 1991). However, the burden of proof can be shifted when the Commissioner's position implicates "new matter" that was not in the notice of deficiency. Petitioners point out that whereas the notice of deficiency determined that they had engaged in "prohibited transactions" forbidden in section 4975(c)(1)(C) and (F)--involving "furnishing of goods, services", etc., and "receipt of con-

Abbot Fire & Safety, Inc.

In 2001 Mr. Fleck identified Abbott Fire & Safety, Inc. ("AFS"), as an attractive business opportunity. AFS specialized in providing alarms and fire protection, hood suppression systems, sprinkler systems, backflow inspections, fire extinguishers, and emergency lights for businesses. AFS also engaged in government-mandated compliance testing related to fire suppression and safety. [*P5] Mr. Fleck contacted A.J. Hoyal & Co. ("A.J. Hoyal"), the brokerage firm through which AFS was offered for sale. While Mr. Fleck originally hoped to purchase AFS with a family member as partner, that relative was unable to join the venture. Instead, Mr. Peek, an attorney who had provided legal services to Mr. Fleck in the past, approached Mr. Fleck about joining the venture. (Mr. and Mrs. Fleck are not related to Mr. and Mrs. Peek.)

The IACC

A.J. Hoyal introduced Mr. Fleck to Christian Blees, a certified public accountant ("C.P.A.") at a Colorado Springs accounting firm. Mr. Fleck later introduced Mr. Blees to Mr. Peek. Neither Mr. Fleck nor Mr. Peek knew

Mr. Blees previously. Mr. Fleck and Mr. Peek engaged Mr. Blees and his firm to assist in structuring the purchase of AFS's assets and to perform due diligence on the transaction. Mr. Blees presented to Mr. Fleck and Mr. Peek information on a strategy he identified as the "IACC". On September 6, 2001, Mr. Blees gave to Mr. Fleck and Mr. Peek documents that described the IACC plan. This strategy called for the participant to establish a self-directed individual retirement account ("IRA"), transfer funds into that IRA from an existing IRA or section 401(k) plan account, [*P6] set up a new corporation, sell shares in the new corporation to the self-directed IRA, and use the funds from the sale of shares to purchase a business interest.

In addition to describing the plan, the IACC documents included an extensive discussion and an opinion letter from Mr. Blees about prohibited transactions under section 4975, which state that such transactions would be detrimental to the IACC plan's tax objectives. The documents warned that "the taxpayer could not engage in transactions with the IRA that the IRS would determine to be 'prohibited transactions'". Also included in the documents was a letter from the accounting firm, which instructed:

> An important distinction to always recognize is that any actions you take on behalf of the corporation must be taken by you as an agent for the corporation and not by you personally. Any business done by the corporation must be done in its status as a corporation and realizing that you are acting as an agent of the corporation only. The corporation should exercise care to hold itself out at all times to the public as a corporation and not as some other type of entity, or as an extension of you personally.
>
> * * * *
>
> Failure to properly manage the corporations [sic] affairs, or to conduct business in any manner other than at arms length could result in adverse effects to the corporation, your IRA, and to you personally. This might include, but is not limited to, the assessment of additional income taxes, penalties and interest from various taxing authorities.

[*P7] None of the IACC documents indicate that Mr. Fleck or Mr. Peek informed their accountant that they might guarantee

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sideration * * * in connection with a transaction involving the income or assets of a plan"--the Commissioner now relies on section 4975(c)(1)(B), which prohibits "indirect * * * extension of credit". We note that the notices of deficiency make no mention of the loan guaranties. To the extent that this issue would require different evidence, it could constitute "new matter". However, we need not resolve that question, see Dagres v. Commissioner, 136 T.C. 263, 279 (2011), since the material facts are not actually in dispute, and we can resolve the case by a mere preponderance of the evidence.

loans for the new corporation as part of their planned acquisition of AFS's assets; and the documents included no advice to the effect that an extension of credit or personal guaranty between petitioners and the new corporation would not be considered prohibited transaction for purposes of section 4975.

Mr. Peek completed and submitted an "IACC Application" and, in response, received the "IACC Plan for FP Company", a document that outlined a plan for the purchase of AFS's assets. Mr. Fleck and Mr. Peek subsequently implemented this plan and compensated Mr. Blees and his firm for structuring the purchase and performing due diligence. Both Mr. Fleck and Mr. Peek were aware of the compensation.

Implementing IACC with FP Company

Mr. Fleck and Mr. Peek each established at Vista Bank accounts intended to be self-directed IRAs, over which they each retained all discretionary authority and control concerning investments. Mr. Fleck rolled over funds on August 17, 2001, into his IRA (the "Fleck Vista IRA"), from an existing account maintained for his benefit at the Allied Domesq 401(k) Retirement Plan. Mr. Peek rolled over funds on August 30, 2001, into his IRA (the "Peek Vista IRA"), from an existing [*P8] account maintained for his benefit at Charles Schwab. Neither Mr. Fleck nor Mr. Peek contributed to the other's IRA.

On August 27, 2001, the articles of incorporation for FP Company, Inc. ("FP Company") were filed with the Colorado Secretary of State. At formation, Mr. Fleck and Mr. Peek intended that FP Company would purchase the assets of AFS and engage in the retail sale of fire suppression systems.

On September 11, 2001, each IRA purchased 5,000 shares of newly issued stock in FP Company for $309,000 and thereby acquired a 50% interest in FP Company. The Peek Vista IRA made its purchase at Mr. Peek's direction, and the Fleck Vista IRA made its purchase at Mr. Fleck's direction. In so doing, Mr. Peek and Mr. Fleck both intended that FP Company would purchase the assets of AFS. At the time of purchase, both Mr. Peek and Mr. Fleck also intended to serve as corporate officers and directors of FP Company.

In a transaction closed in mid-September 2001 (but with an agreed effective date of August 28, 2001), FP Company acquired most of AFS's assets for a price of $1,100,000, consisting of: (a) $850,000 in cash (derived from (i) a $450,000 bank loan to FP Company from a credit union and (ii) $400,000 of the proceeds of the sale of FP Company's stock to the IRAs); (b) a $50,000 promissory note from FP Company to A.J. Hoyal (the broker); and (c) a $200,000 promissory note from [*P9] FP Company to the sellers, secured by personal guaranties from Mr. Fleck and Mr. Peek.

As part of Mr. Fleck's and Mr. Peek's personal guaranties, a deed of trust on their personal residences was recorded in El Paso County, Colorado, on September 17, 2001. Mr. Fleck and Mr. Peek were grantors, and Leslie and Carol Heinrich, the shareholders of the corporation selling AFS's assets, were the grantees of the deed of trust. The guaranties remained in effect until the sale and merger of FP Company in 2006.

Operation of FP Company d.b.a. Abbott

On September 25, 2001, FP Company filed a Statement of Change of Registered Officer or Registered Agent with the Colorado Secretary of State, which named Mr. Peek as the new registered agent of FP Company. Also on September 25, FP Company filed two Certificates of Assumed or Trade Name, indicating that it would hereafter do business as "Abbott Fire & Safety, Inc." and "Abbott Fire Extinguisher Company, Inc."

From 2001 until the 2006 sale, Mr. Fleck and Mr. Peek were the only persons to serve as corporate officers and directors of FP Company.

[*P10] Subsequent transactions involving the Fleck and Peek IRAs

In 2002 Mr. Fleck and Mr. Peek's accountants informed them that Vista Bank was terminating its services as custodian of the Fleck Vista IRA and the Peek Vista IRA. Consequently, they transferred the Fleck Vista IRA and the Peek Vista IRA to First Trust Co. of Onaga (to become the "Fleck Onaga IRA" and the "Peek Onaga IRA"). Each man intended the new account to be self-directed. In each new IRA the sole asset was the shares of FP Company previously held in the Vista IRAs.

In 2003 Mr. Fleck converted half of the Fleck Onaga IRA to a Roth IRA at the same bank (the "Fleck Roth IRA"); and Mr. Peek converted half of the Peek Onaga IRA to a Roth IRA (the "Peek Roth IRA"). In 2004 each transferred the remaining half of his Onaga IRA into his Roth IRA, so that thereafter each Roth IRA owned 50% of the stock of FP Company. Mr. Fleck and Mr. Peek each reported the fair market values of the converted portions of their accounts as taxable income for 2003 and 2004.

[*P11] 2006 sale and merger of FP Company

In 2006 the Roth IRAs sold FP Company to Xpect First Aid Co. Each Roth IRA received payments on the following dates and in the following amounts for its 50% interest in FP Company:

Date	Payment
3/14/2006	$1,385,920
4/5/2006	114,713
9/14/2006	63,932
11/9/2006	9,156
4/30/2007	94,471
Total	1,668,192

Following these payments, neither the Fleck Roth IRA nor the Peek Roth IRA owned any interest in FP Company, and neither Mr. Fleck nor Mr. Peek had any involvement with FP Company or Xpect First Aid Co.

Administrative actions

Both the Flecks and the Peeks timely filed Federal income tax returns on Forms 1040, "U.S. Individual Income Tax Return", for the years 2006 and 2007. The IRS examined those returns, adjusted petitioners' income to include capital gain from the sale of FP Company stock,[4] and in the alternative imposed excise tax [*P12] for excess contributions to Mr. Fleck's and Mr. Peek's Roth IRAs during 2006. The IRS issued statutory notices of deficiency to the Peeks on December 9, 2010, and to the Flecks on December 14, 2010.

The Peeks timely mailed their petition to this Court on March 8, 2011; and the Flecks timely mailed their petition to this Court on March 14, 2011. At the time they filed their petitions, both the Flecks and the Peeks resided in Colorado.

OPINION

I. IRAs and prohibited transactions

HN2 A taxpayer who invests his money in the hope of making a gain over a period of years --whether to fund his retirement or for any other purpose--normally must pay tax on that gain as he realizes it. Sec. 1001(a), (c). His payment of the tax from time to time diminishes the size of his investment and thereby, to some extent, diminishes his future gains. However, a taxpayer may create an "individual retirement account", which is exempt from tax under section 408(e)(1) and in which his investment can therefore increase until his retirement without being diminished by income tax liability. As long as the account qualifies as an IRA, the taxpayer-investor is not liable for income tax

[4] As a result of the increased income, the IRS also made computational adjustments to exemption amounts, student interest deductions (for the Flecks only), itemized deductions, and self-employment tax.

on the gains, so that the undiminished investment account can earn maximum returns until the time comes for payout, when the taxpayer will finally owe income tax on those greater gains. [*P13] Under section 408, the benefit of the traditional IRA is thus deferral of income tax liability on retirement investment gains.[5] Mr. Fleck and Mr. Peek therefore used IRAs to make their investments in FP Company, with the intention of deferring until retirement their income tax liability on the gain they hoped for (and did experience) from that investment.

However, *HN3* IRAs are subject to special rules, including the provision in section 408(e)(2)(A)[6] that an account ceases to qualify as an IRA if "the individual for whose benefit any individual retirement account is established * * * engages in any transaction prohibited by section 4975". The IRS contends that, under that provision, the Fleck Vista IRA, the Peek Vista IRA, and their successor IRAs ceased to qualify as IRAs as of the first day of 2001 through 2006 because Mr. Fleck and Mr. Peek made loan guaranties that were "prohibited transactions" [*P14] under section 4975(c)(1)(B).[7] The IRS therefore concludes that the IRAs' assets are, under section 408(e)(2)(B),[8] deemed to have been distributed to Mr. Fleck and Mr. Peek, who both therefore owe income tax on the gain on sale in 2006 and 2007. The petitioners dispute the IRS's contention that any prohibited transactions occurred, and instead contend that the IRAs remained qualified as such and therefore remained exempt from tax under section 408(e)(1).

II. Loan guaranties as prohibited transactions

The IRS argues that Mr. Fleck's and Mr. Peek's personal guaranties of the $200,000 promissory note from FP Company to the sellers of AFS in 2001 as part of FP Company's purchase of AFS's assets were prohibited transactions. *HN7* Section 4975(c)(1)(B) prohibits "any direct or indirect * * * lending of money or other extension of credit between a [retirement] plan and a disqualified person". (Emphasis added.) The petitioners counter that Mr. Fleck's and Mr. Peek's [*P15] personal guaranties were not prohibited transactions because they did not involve "the plan" (i.e., in this case, the IRAs), whereas the extension of credit prohibited under section 4975(c)(1)(B) is "between a plan and a disqualified person".[9] (Emphasis added.) They acknowledge that a loan guaranty can fall within the prohibition, because, though it is not a direct extension of credit (i.e., a loan), it is an indirect extension of credit. See Janpol v. Commissioner, 101 T.C. 518, 527 (1993) ("An individual who guarantees re-

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[5] To the extent Mr. Fleck and Mr. Peek attempted to use Roth IRAs under section 408A, their desired tax benefit was slightly different. A taxpayer investing through a Roth IRA does not exclude qualifying contributions to the Roth IRA from income, but once in the Roth IRA, investments grow tax free and qualifying distributions from the Roth IRA are not subject to tax. See sec. 408A. Because the IRAs ceased to qualify before the attempted Roth conversion, the Roth IRA rules of section 408A have no application in these cases.

[6] *HN4* Section 408(e)(2)(A) provides: "If, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or his beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year."

[7] *HN5* Section 4975(c)(1) enumerates categories of prohibited transactions, including "any direct or indirect-- * * * (B) lending of money or other extension of credit between a plan and a disqualified person".

[8] *HN6* Section 408(e)(2)(B) provides: "In any case in which any account ceases to be an individual retirement account by reason of subparagraph (A) as of the first day of any taxable year, paragraph (1) of subsection (d) applies [i.e., "any amount paid or distributed * * * shall be included in gross income by the payee or distributee"] as if there were a distribution on such first day in an amount equal to the fair market value (on such first day) of all assets in the account (on such first day)."

[9] *HN8* Section 4975(e)(2)(A) defines "disqualified person" as a "fiduciary," which is itself defined in section 4975(e)(3) as "any person who * * * exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets". See Swanson v. Commissioner, 106 T.C. 76, 88 n.13 (1996). The parties stipulated that Mr. Fleck and Mr. Peek each retained all authority and control over his Vista IRA and its successor IRAs, and that each used this discretion to direct their IRAs to invest in FP Company. Thus, Mr. Fleck and Mr. Peek were "disqualified person[s]" as to their IRAs for purposes of this section.

payment of a loan extended by a third party to a debtor is, although indirectly, extending credit to the debtor"). But petitioners argue that the prohibition applies only to an extension of credit that, whether direct (like a loan) or indirect (like a loan guaranty), is "between a plan and a disqualified person". The loan guaranties at issue were between disqualified persons (Mr. Fleck and Mr. Peek) and an entity other than the plans--i.e., FP Company, an entity owned by the IRAs, rather than the IRAs themselves.

[*P16] This reading of the statute, however, would rob it of its intended breadth. *HN9* Section 4975(c)(1)(B) prohibits "any direct or indirect * * * extension of credit between a plan and a disqualified person". (Emphasis added.) The Supreme Court has observed that when Congress used the phrase "any direct or indirect" in section 4975(c)(1), it thereby employed "broad language" and showed an obvious intention to "prohibit[] something more" than would be reached without it. Commissioner v. Keystone Consol. Indus., Inc., 508 U.S. 152, 159-160, 113 S. Ct. 2006, 124 L. Ed. 2d 71 (1993). As the Commissioner points out, if the statute prohibited only a loan or loan guaranty between a disqualified person and the IRA itself, then the prohibition could be easily and abusively avoided simply by having the IRA create a shell subsidiary to whom the disqualified person could then make a loan. That, however, is an obvious evasion that Congress intended to prevent by using the word "indirect". The language of section 4975(c)(1)(B), when given its obvious and intended meaning, prohibited Mr. Fleck and Mr. Peek from making loans or loan guaranties either directly to their IRAs or indirectly to their IRAs by way of the entity owned by the IRAs.

III. Tax consequences of the guaranties on the sale of stock

The IRS's two notices of deficiency issued to petitioners for 2006 and 2007 are similar, and the one issued to the Flecks asserted:

> [*P17] The prohibited transaction triggered a liquidation of the IRAs in the [sic] 2001. Following that liquidation, the stock of FP Company Inc. is treated as owned by the [sic] Fleck and another individual [i.e., Mr. Peek] personally. Consequently, Fleck and the other individual are taxed personally on any gain on the sale of such stock.

Petitioners seem to argue that the IRS's notices of deficiency issued for 2006 and 2007 are somehow too late (because the loan guaranties were made in 2001), and that in the absence of an earlier notice of deficiency the IRAs remained exempt. Petitioners suggest that if the IRAs did not lose their exemption until 2006, then petitioners would have realized ordinary income in that year, rather than the capital gain determined in the notices; and they argue that since the notices did not make that particular adjustment, the notices are somehow inadequate to support an assessment of tax based on capital gains. This argument either misconstrues the tax consequences to an individual who engages in prohibited transactions with respect to an IRA or perhaps exaggerates the importance of the wording of the notices. The notices determined deficiencies for 2006 and 2007 on the basis of a prohibited transaction that took place in 2001. We now redetermine those 2006 and 2007 deficiencies and decide (1) whether the accounts that held the FP Company stock were IRAs in 2006 when the stock was sold (we hold they were not), (2) when they ceased to be IRAs and therefore exempt from income tax (we hold in 2001), and (3) the tax consequences of their non-exemption (we hold Mr. [*P18] Fleck and Mr. Peek are liable for tax on the capital gains realized in 2006 and 2007 from the sale of the FP Company stock).

The loan guaranties were not a once-and-done transaction with effects only in 2001 but instead remained in place and constituted a continuing prohibited transaction, thus preventing Mr. Fleck's and Mr. Peck's accounts that held the FP Company stock from being IRAs in subsequent years.[10] On January 1, 2006, it remained true that Mr. Fleck and Mr. Peek guaranteed the loan to FP Company; if FP Company defaulted, they would pay. By its nature, the loan guaranty that each man made put him and his account in an indirect lending relationship that would persist until the loan was paid off.

Consequently, under section 408(e)(2)(A), each original account holding the FP Company stock ceased to qualify as an IRA in 2001. In 2003 and 2004 when Mr. Fleck and Mr. Peek established Roth IRAs, those accounts ceased to be Roth IRAs when they funded the accounts with FP Company stock, because the prohibited transactions continued as to those accounts. See *HN10* sec. 408A(a) ("Except as provided in this section, a Roth IRA shall be treated for purposes of this title in [*P19] the same manner as an individual retirement plan"). For the same reasons, the accounts holding the FP Company stock when the stock was sold in 2006 were not Roth IRAs, and the gains from the sale realized in 2006 and 2007 were not exempt from tax. The tax liability from the gain is properly attributable to Mr. Fleck and Mr. Peek as the creators and beneficiaries of the accounts that sold the FP Company stock. See secs. 671, 408(a), (e)(2)(A)(i). Petitioners have not challenged the IRS's calculation of gain on the sale or asserted that they were entitled to a higher basis in the stock than what the IRS allowed. They were therefore liable for tax on the gains realized in the sale transaction as determined in the notices of deficiency.[11]

[*P20] IV. Accuracy-related penalties

A. Substantial understatements

The IRS determined that the Flecks and the Peeks are liable for a 20% accuracy-related penalty because their underpayments were "substantial understatement[s] of income tax" under section 6662(b)(2). *HN11* By definition, an understatement of income tax is substantial if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return. Sec. 6662(d)(1)(A). Pursuant to section 7491(c), the Commissioner bears the burden of producing sufficient evidence showing that the imposition of the penalty is appropriate in a given case. Higbee v. Commissioner, 116 T.C. 438, 446 (2001). He has met this burden of showing substantial understatements of income tax for 2006, since the adjustments for 2006 in the notices of deficiency result in deficiencies that exceed the requisite amounts. The same cannot be said for the 2007 deficiencies; consequently, the Commissioner also maintains that both the 2006 and 2007 underpayments in these cases were attributable to "negligence or disregard of rules or regulations". Sec. 6662(b)(1).

B. Negligence or disregard

HN12 For purposes of section 6662, "the term 'negligence' includes any failure to make a reasonable attempt to comply with the provisions of this title [i.e. 26 [*P21] U.S.C.]". Sec. 6662(c). Negligence is defined as a lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Neely v. Commissioner, 85 T.C. 934 (1985). The term "disregard" includes any careless, reckless, or intentional disregard of the rules or regulations. Sec. 6662(c).

The underpayments in these cases result from petitioners' failures to report capital gain income that they realized from the 2006 sale of FP Company stock; instead petitioners con-

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[10] Since the guaranties (i.e., the prohibited transactions) continued through the time of the sale of FP Company stock in 2006, we do not address what, if any, requirements there are to subsequently reform or resuscitate an IRA that, pursuant to the provisions in section 408(e)(1), has "ceased to be an individual retirement account".

[11] In the alternative, the IRS agues that Mr. Fleck and Mr. Peek owe excise tax on the excess contributions to their successor IRAs under section 4973(a). While section 4973(a) imposes an excise tax equal to 6% of the excess contribution made to a traditional/Roth IRA, this tax is imposed only for each subsequent year in which the excess contribution remains in the IRA. Under our holding here that when the IRAs engaged in prohibited transactions, they ceased to be IRAs and the value of the IRAs' assets constituted deemed distributions to Mr. Peek and Mr. Fleck personally, any excessive contribution to a new IRA was self-corrected and no excise tax would be due. We therefore do not address further this alternative theory.

tended that IRAs held the FP Company stock when the stock was sold and, therefore, the realized gains were not taxable. However, Mr. Fleck and Mr. Peek were well aware that prohibited transactions listed in section 4975 could be fatal to their IRA arrangements, because both the IACC information they received and an opinion letter from their accountant discussed section 4975 in detail. The IACC information expressly stated: "the taxpayer could not engage in transactions with the IRA that the IRS would determine to be 'prohibited transactions'".

HN13 Section 4975(c)(1)(B) clearly provides that any "indirect * * * lending of money or other extension of credit between a plan and a disqualified person" is a prohibited transaction. As we have held, Mr. Fleck's and Mr. Peek's personal guaranties to FP Company were "indirect * * * extension[s] of credit" to their [*P22] IRAs and were prohibited transactions, see Janpol v. Commissioner, 101 T.C. at 527, and no one advised them otherwise. Given Mr. Fleck's and Mr. Peek's knowledge about the hazards of prohibited transactions and their personal involvement with the FP Company transactions (in particular, their personal guaranties), we conclude that petitioners were negligent when they failed to report income from the sales of FP Company stock after Mr. Fleck and Mr. Peek had engaged in a prohibited transaction.

C. Reasonable cause and good faith

HN14 Once the Commissioner meets this burden, the taxpayer must come forward with persuasive evidence that the Commissioner's determination is incorrect, Rule 142(a); Higbee v. Commissioner, 116 T.C. at 447. Petitioners argue that, even if they owe tax on the gain from the sale of FP Company, they acted with reasonable cause and in good faith when they failed to report the capital gains at issue, because they relied on advice provided by Mr. Blees, the C.P.A. *HN15* See sec. 6664(c) (accuracy-related penalty is not due with respect to any portion of an underpayment if it is shown that there was reasonable cause and taxpayer acted in good faith with respect to that portion). However, as Mr. Fleck and Mr. Peek knew, Mr. Blees was himself not a disinterested professional but rather an active promoter of the IACC. A "promoter" is "'an adviser who participated in [*P23] structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction.'" 106 Ltd. v. Commissioner, 136 T.C. 67, 79 (2011) (quoting Tigers Eye Trading, LLC v. Commissioner, T.C. Memo. 2009-121), aff'd, 684 F.3d 84, 401 U.S. App. D.C. 288 (D.C. Cir. 2012). What they received from Mr. Blees was not advice so much as a sales pitch.

Because of Mr. Blees's role as promoter, Mr. Fleck and Mr. Peek could not reasonably and in good faith rely on that advice. See 106 Ltd. v. Commissioner, 136 T.C. at 79 ("promoters take the good-faith out of good-faith reliance"). As the parties have stipulated, Mr. Blees sold to Mr. Fleck and Mr. Peek the IACC plan, which was later used to structure the purchase of AFS's assets. Mr. Blees was thus a promoter, and Mr. Fleck and Mr. Peek could not reasonably and in good faith rely on his advice to adopt the IACC.

Moreover, there is no indication that Mr. Fleck and Mr. Peek informed their accountant of their intention to personally guarantee FP Company loans, or that Mr. Blees gave them any advice that their personal guaranties would not be a prohibited transaction under section 4975. Rather, they were warned not to engage in any transactions that "the IRS would determine to be a 'prohibited transaction'".

[*P24] Since Mr. Blees's advice did not address the issue of personal guaranties, we conclude that petitioners did not rely on their accountant's advice with regard to the prohibited transactions in these cases, and did not have reasonable cause or act in good faith in failing to report the capital gains in these cases.

We therefore sustain the imposition of the accuracy-related penalty under section 6662(a) for both years in issue in both cases.

To reflect the foregoing,

Decisions will be entered under Rule 155.

H

Tax Court & Board of Tax Appeals Memorandum Decisions

Joseph R. Rollins v. Commissioner, TC Memo 2004-260 , Code Sec(s) 4975.

JOSEPH R. ROLLINS, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 1562]

Code Sec(s):	4975
Docket:	Dkt. No. 598-03.
Date Issued:	11/15/2004.
Judge:	Opinion by Chabot, *J.*
Tax Year(s):	Years 1998, 1999, 2000.
Disposition:	Decision for Commissioner.

HEADNOTE

1. Penalty excise taxes—prohibited transactions—plan loans—disqualified person. CPA was liable for penalty excise taxes on loan transactions between his wholly owned accounting firm's profit sharing plan and related cos. with respect to which he held varied ownership interests and served as both treasurer and registered agent: loans came under Code Sec. 4975(c)(1)(D) 's prohibited transaction bar where taxpayer, who by virtue of his fiduciary and ownership status was disqualified person, failed to disprove indications that he dealt with plan assets for his own benefit. Taxpayer signed both plan loan checks and borrower cos.' demand notes, held largest ownership stake in borrower cos. when loans were made, and didn't refute evidence that he benefited at least indirectly from transactions by increasing his equity interest in borrowers. Also, facts that transactions may have also benefited plan and that taxpayer didn't receive direct asset transfers weren't dispositive.

Reference(s): ¶ 49,755.01(35) ;¶ 49,755.01(60) Code Sec. 4975

2. Failure to file returns penalties—penalty excise taxes—burden of proof and production—reasonable cause. Failure to file returns penalties were upheld against CPA/financial advisor with respect to his Code Sec. 4975(c)(1)(D) prohibited loan transactions: IRS met its burden of production with proof that taxpayer never filed Forms 5330 reporting subject transactions; and taxpayer's self-serving belief that transactions weren't subject to Code Sec. 4975 wasn't reasonable cause for not filing.

Reference(s): ¶ 66,515.14(5) ;¶ 74,915.03(15) Code Sec. 6651;Code Sec. 7491;Code Sec. 4975

Syllabus

Official Tax Court Syllabus

P caused the 401(k) plan of his wholly owned company to lend money to three entities in which P owned minority interests. P's company is the sole [pg. 1563] trustee of, and the administrator of, the 401(k) plan. P also acted on the part of the borrower entities in agreeing to the loans.

1. Held: Each of the loans was a "prohibited transaction" within the meaning of sec. 4975(c)(1)(D), I.R.C. 1986. P, a disqualified person, is liable for excise taxes under sec. 4975(a) and (b), I.R.C. 1986; amounts to be determined.

2. Held, further, P is liable for additions to tax under sec. 6651(a)(1), I.R.C. 1986, for failure to file excise tax returns; amounts to be determined.

Counsel

Joseph R. Rollins, pro se.

Denise G. Dengler, for respondent.

CHABOT, *Judge*

MEMORANDUM OPINION

Respondent determined deficiencies in excise taxes under section 4975[1] (prohibited transactions) and additions to tax under section 6651(a)(1) (failure to file tax return) against petitioner as follows:

	Deficiencies		Additions to Tax
Year or Taxable Period	Sec. 4975(a)	Sec. 4975(b)	Sec. 6651(a)(1)

1998	$ 5,231.80	---	$1,307.95
1999	14,576.97	---	3,644.24
2000	24,448.50	---	6,112.13
Period ending Oct. 9, 2002	---	$164,228.39	---

After concessions by respondent,[2] the issues for decision are as follows:

(1) Whether any of petitioner's company's section 401(k) plan's loans to entities partially owned by petitioner constituted prohibited transactions within the meaning of section 4975.

(2) If any of the loans were prohibited transactions, then whether petitioner had reasonable cause for any of his failures to file excise tax returns for 1998, 1999, and 2000.

Background

The instant case was submitted fully stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioner resided in Atlanta, Georgia.

Petitioner is a certified public accountant and a registered investment adviser; also, he holds various certifications in the area of financial planning and investment managing, including certified employee benefits specialist, certified financial planner, and charter financial consultant.

1. *The Plan*

Petitioner owns 100 percent of Rollins & Associates, P.C., a certified public accounting firm, hereinafter sometimes referred to as Rollins. Rollins has a section 401(k) profit-sharing plan, known as Rollins & Associates, P.C. 401(k) Profit Sharing Plan hereinafter sometimes referred to as the Plan. The Plan's predecessor dates back at least to 1985.

At all times relevant herein, the Plan was tax-qualified under section 401(a), and the Plan's underlying trust was exempt from tax under section 501(a). [pg. 1564]

Rollins has been the sole trustee under the Plan since 1985. The trustee is responsible for the following items, as well as other items listed in the Plan's governing instrument: investing, managing, and controlling the Plan's assets (subject to the direction of an investment manager if the trustee appoints one); paying benefits required under the Plan at the direction of the administrator; and maintaining records of receipts and disbursements. The trustee has the power to invest and reinvest the Plan's assets in such securities and property, real or personal, wherever situated, as the trustee shall deem advisable.

Under the Plan, Rollins is to designate the Plan's administrator; if Rollins does not designate an administrator, then Rollins is to function as the administrator. Rollins has not designated an administrator.

Petitioner owns 100 percent of Rollins Financial Counseling, Inc., a registered investment advisory company, hereinafter sometimes referred to as Rollins Financial. In November 1993, Rollins entered into an investment advisory agreement with Rollins Financial whereby Rollins Financial was to provide financial counseling services to Rollins. The agreement provides that petitioner, as Rollins Financial's CEO, "will make all investment decisions on behalf of [Rollins] *** . The recommendations developed by [petitioner] are based upon the professional judgment of [petitioner]".

2. *The Loans*

a. *Overall*

As to each of the loans shown in table 1, petitioner made the decision to lend the Plan's money in the indicated amount to the indicated borrower: Jocks & Jills Charlotte, Inc., hereinafter sometimes referred to as J & J Charlotte; Eagle Bluff Golf Club, LLC, hereinafter sometimes referred to as Eagle Bluff; or Jocks and Jills, Inc. J & J Charlotte, Eagle Bluff, and Jocks and Jills, Inc., are hereinafter sometimes referred to collectively as the Borrowers.

Table 1

Loan Date	Borrower	Amount
May 29, 1996	J & J Charlotte	100,000
June 7, 1996	J & J Charlotte	00,000
June 12, 1996	J & J Charlotte	75,000
July 8, 1996	J & J Charlotte	25,000
Sept. 9, 1996	J & J Charlotte	25,000
May 20, 1997	Eagle Bluff	50,000
Sept. 2, 1998	Jocks and Jills, Inc.	200,000
Nov. 20, 1998	Jocks and Jills, Inc.	50,000
Dec. 31, 1998 /1/	Jocks and Jills, Inc.	25,000
Jan. 26, 1999	Jocks and Jills, Inc.	50,000

/1/ The parties' stipulation states that the $25,000 check is dated Nov. 20, 1998. However, the stipulated exhibit shows that the check is dated Dec. 31, 1998, and the check processing stamps are consistent with the latter date. Our finding follows the stipulated exhibit rather than the stipulation.

b. *J & J Charlotte*

J & J Charlotte is a sports theme restaurant located in Charlotte, North Carolina. When J & J Charlotte was incorporated, in September 1994, and on the dates shown supra in table 1, petitioner was the only member of J & J Charlotte's board of directors and was J & J Charlotte's vice president, secretary, and treasurer; on the table 1 dates petitioner also was J & J Charlotte's registered agent.

When J & J Charlotte was incorporated, petitioner owned all 10,000 shares of J & J Charlotte's subscribed stock. By June 30, 1996, 102,000 additional shares were outstanding. On the dates shown supra in table 1, petitioner had an 8.93-percent interest in J & J Charlotte [3] , and his then-wife [pg. 1565] had a 6.70-percent interest. There were 28 other shareholders on June 30, 1996; the next greatest percentage interest was 6.25 percent.

Petitioner signed the Plan's July 8 and September 9, 1996, checks to J & J Charlotte. (The record does not indicate who signed the checks that effectuated the first three loans shown in table 1.) Petitioner signed all five of J & J Charlotte's promissory notes to the Plan, on behalf of J & J Charlotte. Each of these promissory notes was a 12-percent-per-year demand note; each stated that it was secured by all the machinery and equipment at J & J Charlotte.

On January 11, 2000, petitioner paid $150,500 to the Plan as a repayment on the J & J Charlotte loans.

All of the principal of the Plan's loans to J & J Charlotte has been repaid. See supra note 2.

c. *Eagle Bluff*

Eagle Bluff was a golf club located in Chattanooga, Tennessee. From 1994 until Eagle Bluff was sold in 2000, petitioner was Eagle Bluff's treasurer and its registered agent in Georgia. On May 20, 1997, the Plan lent $50,000 to EagleBluff; at this time petitioner had a 26.8-percent interest in Eagle Bluff; his equity amounted to $983,237.45 out of a total of $3,667,212.45. There were more than 80 other partners; the next greatest percentage interest was that of a couple, who between them and their IRA, held an aggregate 8.8197-percent interest. Petitioner invested an additional $307,151.86 in Eagle Bluff between 1997 and 1998, which increased his percent interest to 31.71.

Petitioner signed the Plan's check to Eagle Bluff. Petitioner signed Eagle Bluff's promissory note to the Plan, on behalf of Eagle Bluff. The promissory note was a 12-percent-per-year demand note; the note stated that it was secured by all the property and equipment at Eagle Bluff. At the time of the loan, 12-percent interest was greater than market rate interest.

During 1999, Rollins paid a total of $3,900 of Eagle Bluff's interest obligations to the Plan, because Eagle Bluff was not able to make the payments. During November and December 1999, petitioner paid a total of $20,000, Rollins Financial paid $7,500, and Rollins paid $7,500 of Eagle Bluff's principal obligations to the Plan, because Eagle Bluff was not able to make the payments. All $35,000 of these 1999 principal payments were treated as petitioner's additional equity in Eagle Bluff. Petitioner fully intended he would receive the funds back from his equity when Eagle Bluff was sold.

All of the principal of the Plan's loan to Eagle Bluff has been repaid. See supra note 2.

d. *Jocks and Jills*

Jocks and Jills, Inc., is a corporation located in Atlanta, Georgia. Petitioner was the secretary/treasurer of Jocks and Jills, Inc., in 1998 and 1999, and its registered agent in Georgia in 1998 and 1999. On the dates shown supra in table 1 petitioner had a 33.165-percent interest in Jocks and Jills, Inc. There were more than 70 other partners; the next greatest percentage interest was of a partner who held 4.8809 percent. [4]

Petitioner signed the Plan's November 20, 1998, December 31, 1998, and January 26, 1999, checks effectuating the loans to Jocks and Jills, Inc. [5] (The record does not indicate who signed the check or checks that effectuated the first loan shown supra in table 1.) Petitioner signed Jocks and Jills, Inc.'s promissory notes to the Plan on behalf of Jocks and Jills, Inc. The first promissory note, dated September 2, 1998, was in the amount of $200,000. On January 15, 1999, Jocks and Jills, Inc., made a $25,000 partial repayment of its second loan. The second promissory note, signed on February 22, 1999, was in the amount of $100,000. (From the dates of the loans and the repayment, we gather [pg. 1566] that this promissory note was for the remaining amounts due on the second, third, and fourth loans. The record does not indicate whether promissory notes had been issued at the times the loans were made.) Each of these promissory notes was a 12- percent-per-year demand note; each stated it was secured by all machinery and equipment at Jocks and Jills, Inc.

After a series of monthly Jocks and Jills, Inc., $5,000 checks to the Plan, on January 28, 2000, petitioner paid $155,571.57 to the Plan as a repayment plus interest on the $200,000 Jocks and Jills, Inc., loan.

On December 8, 1999, Jocks and Jills, Inc., paid $100,000 to the Plan as a repayment "in full" on the February 22, 1999, promissory note. The check making this payment had petitioner's stamped signature.

All of the principal of the Plan's loans to Jocks and Jills, Inc., has been repaid. See supra note 2.

3. *Tax Returns*

Petitioner did not file any excise tax returns, Forms 5330, Return of Excise Taxes Related to Employee Benefit Plans, for the relevant taxable periods. The record does not indicate whether the Plan filed any tax returns or information returns for any taxable periods.

4. *U.S. Department of Labor*

On April 16, 2002, respondent sent a letter to the Department of Labor notifying the Department of Labor that respondent was contemplating adjusting petitioner's section 4975 tax liability. This letter was sent pursuant to section 3003(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1203(a)), Pub. L. 93-406, 88 Stat. 829, 998 (ERISA '74). On May 8, 2002, respondent sent another letter to the Department of Labor, stating that the matter was now before respondent's Appeals Office and asking for a response within 60 days.

Discussion [6]

I. *Excise Taxes*

a. *Parties' Contentions*

Respondent contends that petitioner is a disqualified person with respect to the Plan in two capacities: (a) A fiduciary of the Plan (sec. 4975(e)(2)(A)), and (b) the 100- percent owner of Rollins, the employer sponsoring the Plan (subpars.(E) and (H) of sec. 4975(e)(2)). Respondent contends that the Plan's loans to entities in which petitioner had an interest were prohibited transactions because (1) The loans were transfers of the Plan's assets that benefited petitioner (sec. 4975(c)(1)(D)), and (2) the loans were dealings with the Plan's assets in petitioner's own interest (sec. 4975(c)(1)(E)). Respondent contends that petitioner benefited from the loans in that the loans enabled the Borrowers—all entities in which petitioner owned interests—to operate without having to borrow funds at arm's length from other sources. Respondent summarizes the contentions regarding petitioner's role as fiduciary, as follows:

> No documentation was provided of any security interest under the U.C.C. which would have protected the Plan against other creditors of these companies. (Stip., para. 23, 38, 41, 44, 47, 50, 61, 69) Petitioner would have had to authorize any actions the Plan took against the companies and its officers to collect its loans. Petitioner's ownership interest in these companies created a conflict of interest between the Plan and the companies, resulting in dividing his loyalties to these entities. This conflicting interest as a disqualified person who is a fiduciary brought petitioner within the prohibition [pg. 1567] against dealing "with the income or assets of a plan in his own interest or for his own account". I.R.C. § 4975(c)(1)(E).

Petitioner maintains that, as to each of the loans: (1) The interest rate was above market interest and was paid, (2) the collateral was safe and secure and the principal was repaid, and (3) the Plan's assets were thereby diversified and thus the Plan's portfolio's risk level was "significantly lowered". [7] Petitioner acknowledges that he is a disqualified person with regard to the Plan because he owns Rollins, but he contends that (1) none of the Borrowers was a disqualified person, (2) none of the loans was a transaction between him and the Plan, and (3) he "did not benefit from these loans, either in income or in his own account".

We agree with respondent's conclusion as to section 4975(c)(1)(D).

Because of our concerns about how the statute should be applied to the evidence of record, our conclusion that all of the opinions relied on by both sides are fairly distinguishable, and the absence of applicable Treasury regulations, [8] we first consider the background of section 4975.

b. *Background: Sec. 503 (I.R.C. 1954); Sec. 4941 (TRA `69)*

The Internal Revenue Code of 1954, as originally enacted, provided that if a charitable organization (sec. 501(c)(3)) or a trust which is part of an employees plan (sec. 401(a)) engaged in a prohibited transaction, then the entity lost its section 501(a) exempt status.

Sec. 503(a)(1). [9] "Prohibited transaction" was defined as any of certain types of transactions between the entity and certain related persons; the types of transactions involved case-by-case analyses of arm's-length standards— determinations of reasonableness, adequacy, or preferential basis. Sec. 503(c).

In 1969, the Congress concluded that, as applied to private foundations, (1) The arm's-length standards of then-existing law required disproportionately great enforcement efforts, (2) violations of the law often resulted in disproportionately severe sanctions, and (3) at the same time, the law's standards often permitted those who controlled the private foundations to use the foundations' assets for personal noncharitable purposes without any significant sanctions being imposed on those who thus misused the private foundations. See H. Rept. 91-413 (Part 1), 4, 20-21 (1969), 1969-3 C.B 202, 214; S. Rept. 91-552, 6, 28-29 (1969), 1969-3 C.B. 426, 442-443; also see Staff of the Joint Committee on Internal Revenue Taxation, General Explanation of the Tax Reform Act of 1969 (hereinafter sometimes referred to as the TRA `69 Blue Book) 3, 30-31. The Senate Finance Committee described its conclusions as follows:

> To minimize the need to apply subjective arm's-length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law, the committee has determined to generally prohibit self-dealing transactions and to provide a variety and graduation of sanctions, as described below.
>
> The committee's decisions generally in accord with the House bill, are based on the belief that the highest fiduciary standards require that self-dealing not be engaged in, rather than that arm's-length standards be observed.

S. Rept. 91-552, 29 (1969), 1969-3 C.B. 443. To the same effect, see H. Rept. 91- 413 (Part 1), 21 (1969), 1969-3 C.B. 214; see also TRA `69 Blue Book 30-31.

As a result, in the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487 (TRA `69), the Congress removed private foun-[pg. 1568] dations from the old arm's-length self-dealing requirements ( sec. 101(j)(7) of TRA `69) and enacted section 4941 (sec. 101(b) of TRA `69, relating to taxes on self-dealing). See H. Rept. 91-413 (Part 1), 21 (1969), 1969-3 C.B. 214; S. Rept. 91-552, 29 (1969), 1969-3 C.B. 443; see also TRA `69 Blue Book 31.

Section 4941(d)(1) provided the following general definition of self-dealing:

SEC. 4941. TAXES ON SELF-DEALING. * * *

(d) Self-Dealing.—

(1) In general.—For purposes of this section, the term "self-dealing" means any direct or indirect —

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and

(F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.

The Senate Finance Committee illustrated the application of these provisions, in pertinent part, as follows:

> A self-dealing transaction may occur even though there has been no transfer of money or property between the foundation and any disqualified person. For example, a "use by, or for the benefit of, a disqualified person of the income or assets of a private foundation" may consist of securities purchases or sales by the foundation in order to manipulate the prices of the securities to the advantage of the disqualified person.

***

> It has been suggested that many of those with whom a foundation "naturally" deals are, or may be, disqualified persons. However, the difficulties that prompted this legislation in many cases arise because foundations "naturally" deal with their donors and their donors' businesses.
>
> If a substantial donor owns an office building, the foundation should look elsewhere for its office space. (Interim rules provided in the case of existing arrangements are discussed below.) A recent issue (May 1969) of the American Bar Association Journal discussing an instance of an attorney purchasing assets at fair market value from an estate he was representing suggests the problems even in "fair market value" self-dealing:
>
>> The Ethics Committee said that it is generally "improper for an attorney to purchase assets from an estate or an executor or personal representative, for whom he is acting as attorney. Any such dealings ordinarily raise an issue as to the attorney's individual interest as opposed to the interest of the estate or personal representative whom he is representing as attorney. While there may be situations in which after a full disclosure of all the facts and with the approval of the court, it might be proper for such purchases to be made *** in virtually all circumstances of this kind, the lawyer should not subject himself to the temptation of using for his own advantage information which he may have personally or professionally *** "

S. Rept. 91-552, 29, 30-31 (1969), 1969-3 C.B. 443, 444. To the same effect, see also TRA `69 Blue Book 31, 32. [pg. 1569]

c. *Sec. 4975 (ERISA `74)*

By 1974, the Congress reached similar conclusions about the same sorts of transactions involving employees plans.

Section 4975 [10] , enacted by section 2003(a) of ERISA `74, imposes taxes on a disqualified person who participates in a prohibited transaction between a plan and a disqualified person. [11]

The close relationship between the Congress' reaction to the private foundations problems in TRA `69 and the employees plans problems in ERISA `74 is evident in (1) the general structures of sections 4941 (private foundations) and 4975 (employees plans) and (2) the identity of many elements of the definitions of "prohibited transaction" (sec. 4975(c)(1)) and "self-dealing" (sec. 4941(d)(1)). The opening language of the definitions and many of the elements in the definitions (subpars. (A), (B), (C), and (E) of sec. 4941(d)(1) and subpars. (A), (B), (C), and (D) of sec. 4975(c)(1)) are word-for-word identical. The ERISA `74 conference joint statement of managers confirms, at numerous points, the TRA `69 private foundations origins of much of section 4975. H. Conf. Rept. 93- 1280 (1974), 1974-3 C.B. 415:

Fiduciary responsibility rules, in general

> The conference substitute establishes rules governing the conduct of plan fiduciaries under the labor laws (title I) and also establishes rules governing the conduct of disqualified persons (who are generally the same people as "parties in interest" under the labor provisions) with respect to the plan under the tax laws (title II). This division corresponds to the basic difference in focus of the two departments. The labor law provisions apply rules and remedies similar to those under traditional trust law to govern the conduct of fiduciaries. The tax law provisions apply an excise tax on disqualified persons who violate the new prohibited transaction rules; this is similar to the approach taken under the present rules against self-dealing that apply to private foundations. [Id. at 295, 1974- 3 C.B. 456.]

***

Prohibited transactions

> *In general.*—The conference substitute prohibits plan fiduciaries and parties-in-interest from engaging in a number of specific transactions. Prohibited transaction rules are included both in the labor and tax provisions of the substitute. Under the labor provisions (title I), the fiduciary is the main focus of the prohibited transaction rules. This corresponds to the traditional focus of trust law and of civil enforcement of fiduciary responsibilities through the courts. On the other hand, the tax provisions (title II) focus on the disqualified person. This corresponds to the present prohibited transaction provisions relating to private foundations. [2]

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2 Generally, the substitute defines a prohibited transaction as the same type of transaction that constitutes prohibited self-[pg. 1570] dealings with respect to private foundations, with differences that are appropriate in the employee benefit area. As with the private foundation rules, under the substitute, both direct and indirect dealings of the proscribed type are prohibited.

> The prohibited transactions, and exceptions there-from, are nearly identical in the labor and tax provisions. However, the labor and tax provisions differ somewhat in establishing liability for violation of prohibited transactions. Under the labor provisions, a fiduciary will only be liable if he knew or should have known that he engaged in a prohibited transaction. Such a knowledge requirement is not included in the tax provisions. This distinction conforms to the distinction in present law in the private foundation provisions (where a foundation's manager generally is subject to a tax on self-dealing if he acted with knowledge, but a disqualified person is subject to tax without proof of knowledge). [Id. at 306-307, 1974-3 C.B. at 467.]

***

> The substitute prohibits the direct or indirect transfer of any plan income or asset to or for the benefit of a party-in-interest. It also prohibits the use of plan income or assets by or for the benefit of any party-in-interest. As in other situations, this prohibited transaction may occur even though there has not been a transfer of money or property between the plan and a party-in-interest. For example, securities purchases or sales by a plan to manipulate the price of the security to the advantage of a party-in-interest constitutes a use by or for the benefit of a party-in-interest of any assets of the plan. [Id. at 308, 1974-3 C.B. at 469.]

***

> The substitute also prohibits a fiduciary from receiving consideration for his own personal account from any party dealing with the plan in connection with the transaction involving the income or assets of the plan. This prevents, eg., "kickbacks" to a fiduciary.
>
> In addition, the labor provisions (but not the tax provisions) prohibit a fiduciary from acting in any transaction involving the plan on behalf of a person (or representing a party) whose interests are adverse to the interest of the plan or of its participants or beneficiaries. This prevents a fiduciary from being put in a position where he has dual loyalties, and, therefore, he cannot act exclusively for the benefit of a plan's participants and beneficiaries. (This prohibition is not included in the tax provisions, because of the difficulty in determining an appropriate measure for an excise tax.) [Id. at 309, 1974-3 C.B. at 470.]

***

> Following present law with respect to private foundations, under the substitute where a fiduciary participates in a prohibited transaction in a capacity other than that, or in addition to that, of a fiduciary, he is to be treated as other disqualified persons and subject to tax. Otherwise, a fiduciary is not to be subject to the excise tax. [Id. at 321, 1974-3 C.B. at 482.]

After enacting ERISA '74, the Congress took a similar approach in section 4951, enacted by section 4(c)(1) of the Black Lung Benefits Revenue Act of 1977, Pub. L. 95-227, 92 Stat. 11, 18.

d. *Prohibited Transactions*

Each of the transactions, listed supra in table 1, was a loan. Respondent does not contend that any of the transactions fits under section 4975(c)(1)(B) ("any direct or indirect—(B) lending of money or other extension of credit between a plan and a disqualified person"), but focuses only on subparagraphs (D) and (E) of section 4975(c)(1). We consider first whether any of the transactions fits under section 4975(c)(1)(D)—"any direct or indirect—(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan".

Petitioner was a disqualified person with respect to the Plan because (1) he was a fiduciary (sec. 4975(e)(2)(A)), (2) he owned Rollins (sec. 4975(e)(2)(E)), and (redundant in the instant case) (3) he owned at least 10 percent of Rollins (sec. 4975(e)(2)(H)). The transactions were uses by petitioner or for petitioner's benefit, of [pg. 1571] assets of the Plan. These assets of the Plan were not transferred to petitioner. As to each of the transactions before us, petitioner sat on both sides of the table. Petitioner made the decisions to lend the Plan's funds, and petitioner signed the promissory notes on behalf of the Borrowers. This flies in the face of the general thrust of this legislation to stop disqualified persons from dealing with the relevant employees plans or the plans' assets. The Congress replaced prior laws' arm's-length standards and put in their place prohibitions on certain kinds of dealings (with exceptions not relevant to the instant case). The prohibitions were backed up by excise taxes, to be imposed without regard to whether the transactions benefited the employees plans.

However, the Congress chose to carry out this "general thrust" by enacting a series of detailed prohibitions. The question before us at this point is whether petitioner violated one of these detailed prohibitions—direct or indirect use of a plan's assets or income by petitioner or for petitioner's benefit.

From the stipulations and stipulated exhibits we learn that petitioner held the largest interest in each borrower whenever that borrower received a loan from the Plan. Petitioner had an 8.93-percent interest in J & J Charlotte. Petitioner's then-wife had a 6.70-percent interest. Their combined holdings were 2 1/2times as great as the next-largest holding. Petitioner had a 26.8-percent interest in Eagle Bluff—three times as great as the next-largest holding. Petitioner had a 33.165-percent interest in Jocks and Jills, Inc.—6 1/2 times as great as the next-largest holding. [12] When Eagle Bluff was not able to make its payments to the Plan, petitioner made some of the payments, intending (the parties stipulated) that he would receive his money back when the golf club was sold.

The ERISA '74 conference joint statement of managers states: "this prohibited transaction [use of plan assets for the benefit of a disqualified person] may occur even though there has not been a transfer of money or property between the plan and a party-in-interest [disqualified person]." The statement of managers goes on to illustrate that use of a plan's assets to manipulate the price of a security to the advantage of a disqualified person constitutes a prohibited transaction.

In light of the legislative history illustrating the meaning of this statutory provision, it is apparent that the evidentiary record is consistent with a conclusion that petitioner derived a benefit (as significant part owner of each of the Borrowers) from the Borrowers' securing financing without having to deal with independent lenders. That is, it is possible that petitioner derived a benefit. However, it also is possible that petitioner did not derive a benefit. From the evidentiary record herein, we cannot determine which of these possibilities is the more likely one.

When we examine the record for evidence that petitioner did not derive a benefit (e.g., did not receive any money, or did not enhance the values of his investments in the Borrowers), we find nothing. [13]

Petitioner has the burden of proving by a preponderance of the evidence that the loans, or any of them, did not constitute uses of the Plan's income or assets for his own benefit. Rule 142(a); Welch v. Helvering, 290 U.S. 111 [12 AFTR 1456] (1933); Borchers v. Commissioner, 95 T.C. 82, 91 (1990), affd. 943 F.2d 22 [68 AFTR 2d 91-5439] (8th Cir. 1991). On the record before us, petitioner has failed to carry this burden.

Petitioner contends that the loans were good for the Plan, providing diversification and a good return with "safe, secure collateral." In Leib v. Commissioner, 88 T.C. 1474 (1987), the taxpayer sold stock to the employees' pension trust of the professional corporation that he owned. The taxpayer contended that the trust's purchase [pg. 1572] "would qualify as a prudent investment if judged under the highest fiduciary standards." Id. at 1477. We concluded on that issue as follows:

> After a review of the statutory framework and legislative history of section 4975 and the case law interpreting ERISA section 406, we conclude that the prohibited transactions contained in section 4975(c)(1) are just that. The fact that the transaction would qualify as a prudent investment when judged under the highest fiduciary standards is of no consequence. Furthermore, the fact that the plan benefits from the transaction is irrelevant. Good intentions and a pure heart are no defense. *** [Id. at 1481].

Thus, prudence of the investment and actual benefit to the Plan are not sufficient to excuse petitioner from imposition of tax under section 4975(a) if petitioner participated in a prohibited transaction with respect to the Plan.

Respondent directs our attention to O'Malley v. Commissioner, 96 T.C. 644 (1991), affd. 972 F.2d 150 [70 AFTR 2d 92-5455] (7th Cir. 1992), in which we held that a transaction violated section 4975(c)(1)(D) even though the taxpayer "did not receive any direct payments from the Plan". Petitioner correctly points out that the instant case is distinguishable from O'Malley. In O'Malley, the record showed that the plan paid the taxpayer's legal fees, and the taxpayer did not dispute the Commissioner's contention that this use of the plan's assets benefited the taxpayer and thus constituted a prohibited transaction. O'Malley v. Commissioner, 96 T.C. at 650. Petitioner states on brief that in the instant case "there were no expenses paid by the Plan on behalf of the Petitioner." *Firstly*, petitioner's statement on brief cannot substitute for petitioner's failure to provide evidence of record. *Secondly*, as the ERISA '74 conference statement of managers extract shows, even the use of a plan's assets to enhance the price of a security can constitute a benefit within the meaning of section 4975(c)(1)(D). H. Conf. Rept. 93-1280, supra at 303, 1974-3 C.B. at 469. The record in the instant case does not enable us to find that the loans did not enhance, or were not intended to enhance, the values of petitioner's equity interests in the Borrowers.

Petitioner contends that Etter v. J. Pease Const. Co., Inc., 963 F.2d 1005 (7th Cir. 1992), is "a critical case in this area". The cited Court of Appeals opinion deals with a number of issues. We assume petitioner intends us to focus on that part of the Etter opinion dealing with whether an employees plan's investment in a joint venture "constituted a use of the *** [employees plan's] assets for the benefit of a party in interest [in the tax law, a 'disqualified person'] and, thus, is prohibited by 29 U.S.C. § 1106(a)(1)(D) [sec. 4975(c)(1)(D)]." 963 F.2d at 1010. The Court of Appeals summarized as follows the parties' contentions on that issue, and the Court of Appeals' conclusions, idem.:

> Etter [the plan participant] argues that Pease and Miller [the plan trustees] benefitted from the Plan's investment in that they secured various tax advantages while not risking as much of their personal assets. Conversely, appellees [the plan trustees] argue, as the district court found, that by contributing less than 100% of the purchase price Pease and Miller enabled the Plan to take advantage of a valuable opportunity.
>
> These two views of the evidence, as different as they may be, are both permissible, and the district court's account is plausible. Therefore, the finding of the district court "cannot be clearly erroneous." Anderson v. City of Bessemer City, 470 U.S. 564, 574 (1985).

We agree with petitioner that Etter is significant. The Court of Appeals makes it plain that an employees plan's assets could be used for the benefit of a disqualified person, in violation of section 4975(c)(1)(D), even though none of the employees plan's assets were transferred to the disqualified person. The resolution of the benefit issue depends on whether the party having the burden of proof has carried that burden on the basis of the evidence in the record. Our evaluation of the sparse evidence in the record of the instant case, consistent with Etter, convinces us that petitioner has failed to carry his burden of proving that he did not use the Plan's assets for his own benefit. [pg. 1573]

Our conclusion as to section 4975(c)(1)(D) makes it unnecessary for us to determine whether the loans also violated section 4975(c)(1)(E). In particular, we do not decide whether we agree with respondent's contention on brief that petitioner's ownership interests in the Borrowers—

> created a conflict of interest between the Plan and the companies, resulting in dividing his loyalties to these entities. This conflicting interest as a disqualified person who is a fiduciary brought petitioner within the prohibition against dealing "with the income or assets of a plan in his own interest or for his own account". I.R.C. § 4975(c)(1)(E).

We note that the regulation on which respondent relies on this issue—section 54.4975-6(a)(5)(i), Pension Excise Tax Regs. —deals with "the furnishing of office space or a service" and prohibits a fiduciary from causing "a plan to pay an additional fee to such fiduciary *** to provide a service", and prohibits an arrangement "whereby such fiduciary *** will receive consideration from a third party in connection with such transaction." None of these elements is suggested on the record herein, and so it is not readily apparent that this regulation is relevant to this issue.

Also, an analysis of the effect of conflict of interest, without more, as a basis of violation of section 4975(c)(1)(E) should take into account the statutory differences between the ERISA '74 labor law provisions and the tax law provisions. Section 406(b)(1) and (3) of ERISA '74 (codified as 29 U.S.C. 1106(b)(1) and (3)) corresponds to subparagraphs (E) and (F) of section 4975(c)(1). However, the tax law does not have an equivalent of section 406(b)(2) of ERISA '74:

> (b) A fiduciary with respect to a plan shall not—

***

> (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries *** .

The statement of managers, H. Conf. Rept. 93-1280, supra at 309, 1974-3 C.B. at 470, explains this difference between the labor and tax titles as follows:

> In addition, the labor provisions (but not the tax provisions) prohibit a fiduciary from acting in any transaction involving the plan on behalf of a person (or representing a party) whose interests are adverse to the interests of the plan or of its participants or beneficiaries. This prevents a fiduciary from being put in a position where he has dual loyalties, and, therefore, he cannot act exclusively for the benefit of a plan's participants and beneficiaries. (This prohibition is not included in the tax provisions, because of the difficulty in determining an appropriate measure for an excise tax.)

Thus, it appears that a conflict of interest involving a fiduciary's obligations to the other party in a transaction may be actionable under the labor title, but it may be that such a conflict of interest by itself may not be actionable under section 4975(c)(1)(E).

We shall deal with such matters under section 4975(c)(1)(E) when confronted with a record in which we must decide the matters in order to resolve the case.

We hold, for respondent, that each of the loans (supra table 1) constituted a use of the Plan's assets for petitioner's benefit, in violation of section 4975(c)(1)(D).

II. *Failure To File Tax Returns*

In the portion of his brief dealing with the additions to tax for failure to file tax returns, petitioner contends that

—

> Nothing in this case indicates that there was abuse of any kind to the Plan or its participants, nor was there any economic benefit to the Petitioner himself. The Petitioner has significant experience in administering and managing benefit plans, and substantial experience in the asset management of plans. When a taxpayer cannot rely upon the statutory authority itself to support his actions, then the tax-[pg. 1574] ing system becomes sheer folly. *** As the record will show, the Petitioner totally relied upon the statutory integrity of the transaction, and to assert there was any abuse or that any assessment of penalties is warranted is an outrage.

Respondent maintains: (1) Petitioner was obligated to file tax returns for the section 4975(a) taxes; (2) petitioner failed to do so; (3) petitioner did not have reasonable cause for his failure to file tax returns; and (4) such failures result in additions to tax under section 6651(a)(1).

We agree with respondent.

The relevant legal analysis about the application of section 6651(a)(1) to failures to file returns for section 4975 taxes is set forth in Janpol v. Commissioner, 102 T.C. 499 (1994), and need not be repeated here.

Relying on his own understanding of the law, petitioner chose to sit "on both sides of the table in each transaction." Yamamoto v. Commissioner, 73 T.C. 946, 954 (1980), affd. 672 F.2d 924 (9th Cir. 1982). Relying on his own understanding of the law, petitioner did not see any need to file section 4975 tax returns to report any of the transactions. Relying again on his own understanding of the law, petitioner chose to submit the instant case fully stipulated without including evidence to show that he did not benefit from the transactions. In Etter v. J. Pease Const. Co., Inc., 963 F.2d 1005 (7th Cir. 1992), the trustees succeeded in persuading the trial judge that they did not benefit from the employee plan's investment in the joint venture. In the instant case, petitioner failed to persuade the Court that he did not benefit from the transactions.

Petitioner's good-faith belief that he was not required to file tax returns does not constitute reasonable cause under section 6651(a)(1) unless bolstered by advice from competent tax counsel who has been informed of all the relevant facts. Stevens Bros. Foundation, Inc. v. Commissioner, 39 T.C. 93, 133 (1962), affd. on this point 324 F.2d 633, 646 [12 AFTR 2d 5952] (8th Cir. 1963). There is no such evidence in the record in the instant case.

We hold for respondent on this issue.

To take account of the foregoing, including respondent's concessions,

Decision will be entered under Rule 155.

1

Unless indicated otherwise, all section and subtitle references are to sections and subtitles of the Internal Revenue Code of 1986 as in effect for the years and taxable period in issue.

2

On brief, respondent concedes that there were "loan interest payments, which reduce both the § 4975(a)& (b) excise taxes." At another point on brief, respondent concedes that "Petitioner has established that the principal of the loans was repaid; there is still an issue whether the interest was paid." We assume that, where these concessions affect the sec. 4975(a) excise taxes, these concessions may have consequential effects on the determinations of additions to tax under sec. 6651(a)(1).

The parties have not presented any specific dispute as to the extent of these concessions, and thus the instant report does not deal with matter. Any relevant unresolved dispute will be dealt with in proceedings under Rule 155 or as may otherwise be appropriate. See Medina v. Commissioner, 112 T.C. 51 (1999).

Unless indicated otherwise, all Rule references are to the Tax Court Rules of Practice and Procedure.

3

So stipulated. However, the stipulated stock register shows that, on Aug. 28, 1996, before the date of the last loan shown on table 1, petitioner acquired 2,500 shares from another shareholder. This raised petitioner's interest to 11.16 percent.

4

So stipulated. The stipulated exhibit that serves as the foundation of the stipulated conclusions lists "Partners' Allocation Percentages" for Jocks & Jills Restaurant, LLC, a separate entity from Jocks and Jills, Inc. In the absence of an explanation by the parties, we have followed the language of the parties, even to the use of the word "partner" rather than "shareholder".

5

The two $50,000 checks are made out to Jocks and Jills, Inc., but the $25,000 check is made out to Jocks & Jills Restaurants, LLC. See supra note 4.

6

Sec. 7491, relating to burden of proof, was not drawn in issue by either side.

However, for completeness, and in light of petitioner's pro se status, we note the following: Sec. 7491(a) provides for shifting the burden of proof (if certain conditions have been satisfied) with respect to "any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B". Sec. 7491(a)(1). The sec. 4975 taxes involved in the instant case are imposed by subtitle D; the parties have not suggested any subtitle A or B component. Accordingly, sec. 7491(a) cannot operate to shift the burden of proof in the instant case. See, e.g., Jos. M. Grey Pub. Acct., P.C. v. Commissioner, 119 T.C. 121, 123, n.2 (2002), affd. 93 Fed. Appx. 473 [93 AFTR 2d 2004-1626] (3d Cir. 2004).

Sec. 7491(b), relating to statistical information on unrelated taxpayers, does not apply to the instant case.

Sec. 7491(c) imposes on respondent the burden of production with respect to the additions to tax under sec. 6651(a)(1). The parties' stipulation that—"3. Petitioner did not file any excise tax returns, Forms 5330, Return of Excise Taxes Related to Employee Benefit Plans, for the relevant taxable periods." satisfies this obligation; petitioner still has the burden of proving that the determined additions should not be imposed. Higbee v. Commissioner, 116 T.C. 438, 446-447 (2001). But see supra note 2. Finally, the parties' presentation of the instant case fully stipulated does not change the burden of proof. Rule 122(b); Borchers v. Commissioner, 95 T.C. 82, 91 (1990), affd. 943 F.2d 22 [68 AFTR 2d 91-5439] (8th Cir. 1991).

7

The record does not indicate (1) either the magnitude or the nature of the Plan's other assets, or (2) either the magnitude or the timing of the Plan's obligations.

8

We note that sec. 53.4941(d)-2(f), Private Foundation Excise Tax Regs., interprets sec. 4941(d)(1)(E), which is almost exactly the same as sec. 4975(c)(1)(D). Neither side cites this regulation for any purpose. Under the circumstances we do not explore in the instant opinion whether this regulation provides any insight into the meaning of sec. 4975(c)(1)(D).

9

Sec. 503 of the Internal Revenue Code of 1954 was derived from sec. 3813 of the Internal Revenue Code of 1939; that provision had been enacted in 1950.

10

Sec. 4975 provides, in pertinent part, as follows:

SEC. 4975. TAX ON PROHIBITED TRANSACTIONS. * * *

(c) Prohibited Transaction.—

(1) General rule.—For purposes of this section, the term "prohibited transaction" means any direct or indirect—

(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

(B) lending of money or other extension of credit between a plan and a disqualified person;

(C) furnishing of goods, services, or facilities between a plan and a disqualified person;

(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

(E) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or

(F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

11

Sec. 4975(h) requires respondent to notify the Department of Labor before issuing a notice of deficiency with respect to taxes imposed by sec. 4975(a) or (b). Our findings include the parties' stipulations as to two such notifications. Sec. 4975(i) is a cross-reference to coordination procedures under sec. 3003 of ERISA. Petitioner does not contend that the notification was insufficient or that any action of the Department of Labor under ERISA secs. 406 (relating to prohibited transactions), 408 (relating to exemptions from prohibited transactions), 3003 (relating to procedures in connection with prohibited transactions), or 3004 (relating to coordination between the Treasury Department and the Labor Department) affects the instant case. See 29 U.S.C. 1106, 1108, 1203, 1204. Accordingly, we assume that all requirements as to notification of, and coordination with, the Labor Department have been complied with.

12

On brief, petitioner states that his "ownership interest[s] in the entities to which loans were made were roughly 9%, 13% and 24%." Petitioner is correct as to J & J Charlotte. However, his statement on brief substantially conflicts with the parties' stipulations—and the stipulated exhibits—as to Eagle Bluff and Jock and Jills, Inc. Our findings are in accord with the parties' stipulations. Petitioner does not enlighten us as to the source of his statement regarding his ownership interests in Eagle Bluff and Jock and Jills, Inc.

13

Petitioner's denials on brief are not evidence. Rule 143(b); Evans v. Commissioner, 48 T.C. 704, 709 (1967), affd. 413 F.2d 1047 [24 AFTR 2d 69-5273] (9th Cir. 1969).

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