

**To: Leroy Gilbertson
Director, Arizona State Retirement System**

January 23, 2001

**Re: Employer Early
Retirement Program
Benefits**

I01-004 (R00-043)

Question Presented

Eligible public employees receive benefits under the Arizona State Retirement System ("ASRS") based on their years of credited service and their average monthly compensation. Apart from benefits received under the ASRS defined benefit plan, employees may also be paid amounts by their employer under an early retirement program ("ERP"). You have asked if amounts paid under an ERP should be included as "compensation" for purposes of the ASRS plan.

Summary Answer

Benefits paid under an ERP are not "compensation" for employees who joined the ASRS plan after December 31, 1983 (or who were hired earlier and elected to have retirement benefits calculated under the law as amended in 1983), regardless of when the ERP benefits are paid.

For employees who became members of ASRS on or before December 31, 1983 and did not elect to have retirement benefits calculated under the law as amended in 1983, ERP benefits paid at or before termination of employment are "compensation" for purposes of the ASRS plan, but ERP benefits paid thereafter are not.

Background

A. Compensation under the ASRS Plan.

As a condition of employment, eligible public employees become members of the ASRS defined benefit plan ("Plan") and contribute to the plan as provided by law. See A.R.S. §§ 38-711(22), -727 (eligibility for membership in the ASRS Plan), -736 (member contributions). Under the Plan, retirement benefits are based on an employee's years of credited service and average monthly compensation at the "normal retirement date." A.R.S. § 38-757. From 1970 through 1983, the term "compensation" was defined as: the amounts actually received by the participant for remuneration for employment from an employer on an hourly or salaried basis including any incentive compensation, overtime or other irregular payments.

A.R.S. § 38-781.01(5) (1970) (repealed 1995) (current version at A.R.S. § 38-711(7)(2000)). This Opinion refers to this definition as the "1970 Definition of Compensation." While this definition was in effect, "average monthly compensation" was calculated based on the "five contiguous years during which a participant receives his highest compensation within a ten-year period ending with his normal retirement or . . . cessation of employment." A.R.S. § 38-781.01(3)(a)

(1970) (repealed 1995) (current version at A.R.S. § 38-711(5)(a)(2000)).

During the 1983 regular session, the Legislature substantially narrowed the definition of compensation. The amended definition of compensation read:

"Compensation" means the gross amount paid to a participant by an employer as salary or wages, including amounts which are subject to deferred compensation or tax shelter agreements, for services rendered to or for an employer, or which would have been paid to the participant except for the participant's election or a legal requirement that all or part of the gross amount be used for other purposes. Compensation does not include:

(a) Lump sum payments, on termination of employment, for accumulated vacation or annual leave, sick leave, compensatory time or any other form of termination pay.

(b) Damages, costs, attorney fees, interest or other penalties paid pursuant to a court order or a compromise settlement or agreement to satisfy a grievance or claim even though the amount of the payment is based in whole or in part on previous salary or wage levels, except that, if the court order or compromise settlement or agreement directs salary or wages to be paid for a specific period of time, the payment is compensation for that specific period of time.

(c) Payment, at the participant's option, in lieu of fringe benefits which are normally paid for or provided by the employer.

1983 Ariz. Sess. Laws, ch. 293, § 1 (effective January 1, 1984). This Opinion refers to this definition as the "1984 Definition of Compensation."

In 1983, the Legislature also changed "average monthly compensation" to base it on "a period of sixty consecutive months during which a participant receives the highest compensation within the last one hundred twenty months of service during which he made retirement contributions." A.R.S. § 38-781.01(3)(a)(1984) (repealed 1995) (current version at A.R.S. § 38-711(5)(a)(2000)). In the 1985, the Legislature further amended the definition of average monthly compensation by substituting a thirty-six month average for the previous sixty month average. 1985 Ariz. Sess. Laws, ch. 294, § 3.

Since July 1, 1985, the thirty-six month compensation average, based on the 1984 Definition of Compensation, has been the exclusive method of calculating average monthly compensation for employees who became members of the ASRS Plan after December 31, 1983. Employees who became members of the ASRS Plan before that date had a vested contractual right to benefits under the broader 1970 Definition of Compensation. See Ariz. Att'y Gen. Op. I84-039. Nonetheless, those employees may elect to have their retirement benefit computed under the 1984 Definition of Compensation and the thirty-six month compensation average. See A.R.S. § 38-711(5), (7). A member who elects to have retirement benefits calculated under the 1970 Definition of Compensation is eligible only for the sixty-month compensation average. *Id.*

B. ERPs

Some public employers that participate in the ASRS also offer ERPs to their employees. School districts, for example, have offered ERPs as a fringe benefit under A.R.S. § 15-502(A). See Ariz. Att'y Gen. Op. I00-010. Although ERPs vary in their terms, they typically are offered to long-term employees who agree not to work full-time again for the employer in exchange for certain benefits.

Analysis

A. ERP Benefit Payments Are Not "Compensation" under the 1984 Definition of Compensation.

The 1984 Definition of Compensation excludes "[l]ump sum payments, on termination of employment, for accumulated vacation or annual leave, sick leave, compensatory time or any other form of termination pay whether the payments are made in one payment or by installments over a period of time."⁽¹⁾ A.R.S. § 38-711(7). Payments that would not have been made absent the termination of employment are excluded from "compensation" under this definition. See Ariz. Att'y Gen. Ops. I84-097, I85-124.

ERP benefits are paid to an employee in consideration of the employee's long-term employment and agreement to terminate employment. Ariz. Att'y Gen. Op. I00-010. ERP benefits may be paid before, at, or after termination of employment in a single payment or in installments, but must be included as part of the person's contract in his or her final year of employment. *Id.* This Office previously determined that an "incremental increase in salary" in one ERP and other employee benefits in another ERP were forms of termination pay excluded from "compensation" under the 1984 Definition of Compensation. Ariz. Att'y Gen. I84-097. Because benefit payments under ERPs are a type of termination pay, which may be paid in a single payment or in installments, ERP payments are not "compensation" under the 1984 Definition of Compensation.

B. ERP Benefits Paid before or at Termination of Employment or Retirement Are Includible in Compensation under the 1970 Definition of Compensation, but ERP Benefits Paid after Termination of Employment or Retirement Are Not.

The 1970 Definition of Compensation includes "the amounts actually received . . . for remuneration for employment from an employer on an hourly or salaried basis including any incentive compensation, overtime or other irregular payments." A.R.S. § 38-781.01(5) (1970) (current version at A.R.S. § 38-711(7)(2000)). Unlike the 1984 Definition of Compensation, the 1970 definition did not exclude termination pay. Under the earlier, broad definition, any payments (*e.g.* regular wages or salary, bonuses, payments for accrued leave, termination pay or retirement incentive pay) that an employee actually received from an employer in consideration of that person's employment may be included in compensation.⁽²⁾

The definition of "average monthly compensation" applicable to the 1970 Definition of Compensation, however, is limited to "compensation on which [retirement] contributions were remitted during a period of sixty consecutive months during which the member receives the highest compensation within the last one hundred twenty months of credited service." A.R.S. § 38-711(5)(a). "Credited service" is "the number of years standing to the member's credit on the books of ASRS during which the member made the required contributions." A.R.S. § 38-711(9). The term credited service refers to the time a person performs services for an employer within ASRS and receives compensation for those services. *Cf.* A.R.S. § 38-739(C) (credited service for less than a full service year). Consequently, "average monthly compensation" generally includes only amounts received before termination of employment and on which retirement contributions were remitted. In limited circumstances that do not apply to ERP benefits, "average monthly compensation" may include compensation received after a person's employment has ended. For example, the entire amount paid to a teacher who is compensated under a twelve month contract for services rendered in the prior nine months would be included in "average monthly compensation." *Cf.* Ariz. Att'y Gen. Op. I80-195 (university faculty member who was compensated over a twelve month period was eligible to receive retirement benefits at the date employment terminated (May, 1980), rather than the later date (August, 1980) when he ceased receiving his compensation for those services). In that situation, the payments received in the three months after ceasing employment are for services rendered in the prior nine months under a twelve-month contract. This reasoning, however, does not extend to ERP benefits paid after an employee terminates services. Unlike the teacher's twelve-month contract, ERP benefits are not direct payments for services rendered within that year. Rather, the ERP benefits are retirement incentives based on multiple years of service for an employer and the forfeiture of future employment rights. See Ariz. Att'y Gen. Op. I00-010.

For these reasons, if ERP benefits are received after the person's "credited service" for the employer has ended, they are not "compensation within the last one hundred twenty months of credited service" and, therefore, are not used to calculate "average monthly compensation."

Conclusion

Benefits paid under an ERP are not "compensation" for employees who joined the ASRS plan after December 31, 1983 (or who were hired earlier and elected to have retirement benefits calculated under the law as amended in 1983), regardless of when the ERP benefits are paid. For employees who became members of ASRS on or before December 31, 1983 and did not elect to have retirement benefits calculated under the law as amended in 1983, ERP benefits paid at or before termination of employment are "compensation" under the ASRS plan, but ERP benefits paid thereafter are not.

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1. The Legislature added the language "whether the payments are made in one payment or by installments over a period of time" in 1992. 1992 Ariz. Sess. Laws Ch. 320, § 5. This was consistent with an earlier Attorney General's Opinion which concluded that lump sum termination payments paid over time are excluded from the 1984 Definition of Compensation. Ariz. Att'y Gen. Op. I85-124.

2. Although not controlling, federal cases construing the Federal Insurance Contributions Act ("FICA"), 26 U.S.C. § 3101-3128, support this broad interpretation of compensation. *See Social Sec. Bd. v. Nierotko*, 327 U.S. 358, 365 (1946) (noting statutory terms "wages," "employment," and "service" are to be broadly interpreted to "import breadth of coverage"). Under FICA, "wages" subject to employment taxes generally "means all remuneration for employment" unless the remuneration falls within one of the specified exceptions. *See* 26 U.S.C. § 3121(a). In turn "employment" is defined as "any service, of whatever nature, performed . . . by an employee for the person employing him." 26 U.S.C. § 3121(b). Federal courts have construed FICA to apply to termination pay in some circumstances. *See Mayberry v. United States*, 151 F.3d 855, 860 (8th Cir. 1998) (ERISA settlement award based on former employee's length of service and expected pre-layoff earnings held to be FICA wages).

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