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ATTORNEY GENERAL OPINION NO. 86-12

TO: The Honorable Jerry L. Evans
State Superintendent of Public Instruction

STATEHOUSE MAIL

Per Request for Attorney General Opinion

QUESTION PRESENTED:

Is the amount of the premiums paid by a school district in an employer paid fringe benefit package within a "cafeteria plan" included as part of an employee's salary for the purpose of PERSI pursuant to Idaho Code § 59-1302(31)?

CONCLUSION:

Cafeteria plan benefits are included within "salary" as defined by Idaho Code § 59-1302(31) only to the extent an employee has a right to elect to receive cash benefits pursuant to the cafeteria plan. Accordingly, an employee's "salary" for retirement purposes, as well as the employee's retirement benefits and contributions, will be the same whether the employee elects to receive cash or elects to receive alternative benefits with a corresponding reduction in cash received.

ANALYSIS:

A "cafeteria plan" is a type of employee benefit plan recognized by § 125(d) of the Internal Revenue Code. That section defines "cafeteria plan" in pertinent part as a written plan under which:

(a) All participants are employees, and

(b) The participants may choose among two or more benefits, consisting of cash and statutory nontaxable benefits.

For income tax purposes, cafeteria plan benefits are taxable to the employee only to the extent the employee chooses to receive cash pursuant to the cafeteria plan. I.R.C. §§ 61 and 125. You have asked whether such cafeteria plan benefits are included in "salary" as defined in Idaho Code § 59-1302(31) for purposes of the Public Employee Retirement System of Idaho ("PERSI").

Prior to 1984, Idaho Code § 59-1302(31) provided:

> Salary means the total salary or wages payable by all employers to an active member for personal services currently performed, including the cash value of all remuneration in any medium other than cash in the amount reported by all employers for income tax purposes.

Thus, prior to 1984, the definition included only taxable salary or wages. Deferred compensation plan payments were separately addressed in Idaho Code § 59-513. Accordingly, cafeteria plan benefits would have been included in "salary" only to the extent the employee elected to receive cash pursuant to the cafeteria plan. However, in 1984, PERSI sought and obtained an amendment to this section, which added:

> [a]nd also including the amount of any voluntary reduction in salary agreed to by the member and employer where the reduction is used as an alternative form of remuneration to the member.

The 1984 amendment addresses the circumstance in which the employee elects to receive a reduced amount of cash salary and a greater amount of nontaxable benefits. In such a circumstance, "salary" includes the amount by which an employee voluntarily chooses the reduced cash salary in order to receive additional nontaxable benefits.

It has been suggested to our office that the phrase "voluntary reduction in salary agreed to" should be interpreted to include only situations in which employees agree to receive a "reduction" in cash compensation, but not situations in which employees agree to forego an increase in cash compensation. For example, an employee might enter into an agreement with his employer that calls for a base salary of $2,000 per month, but which could be reduced by voluntary agreement by up to $200 per month to purchase certain benefits such as health insurance. Alternatively, an employer and employee could agree that the base salary is $1800 per month, with an add-on of $200 per month of optional benefits, which could include cash salary or benefits such as health insurance.

In the above example, if both employees agreed to receive $1800 of cash salary and $200 benefits, the interpretation suggested above would lead to the anomalous result that the first employee's "salary" would be $2,000 per month and the second employee's "salary" would be $1,800 per month for retirement purposes. Under this interpretation, the two employees' contribution rates and retirement benefits would differ solely on the basis of the words they chose to express their agreements and would not depend upon the substance of those agreements. We can conceive of no rational basis supporting such unequal treatment of employees in determining their contribution rates and retirement benefits.

Such anomalous results are not favored by courts in construing statutes. To the extent the language of a statute is capable of more than one construction, resolution should be in favor of the reasonable operation of the statute. State, ex rel., Evans v. Click, 102 Idaho 443, 631 P.2d 614 (1981). It would appear to be more reasonable to interpret the phrase "any voluntary reduction in salary" to include employee elections to forego increases in salary in order to treat employees equally who have equal salary rights.

We note that "salary reduction" language has been used for some time with respect to income tax laws dealing with deferred compensation arrangements. For example, P.L. 95-615, § 5(e), 92 Stat. 3097 (Nov. 8, 1978), provided:

> (e) Salary reduction regulations defined. For purposes of this section, the term "salary reduction regulations" means regulations dealing with the includibility in gross income (at the time of contribution) of amounts contributed to a plan which includes a trust that qualifies under section 401(a) [subsec. (a) of this section], or a plan described in section 403(a) or 405(a) [26 USCS §§ 403(a) or 405(a)], including plans or arrangements described in subsection (b)(2), if the contribution is made under an arrangement under which the contribution will be made only if the employee elects to receive a reduction in his compensation or to forego an increase in his compensation, or under an arrangement under which the employee is permitted to elect to receive part of his compensation in one or more alternative forms (if one of such forms results in the inclusion of amounts in income under the Internal Revenue Code of 1954 [26 USCS §§ 1, et seq.]). (Emphasis added)

Thus, for internal revenue purposes, salary reduction agreements are defined to include arrangements under which an employee elects (1) to reduce his compensation, (2) to forego an increase in his compensation, or (3) to elect to receive part of his compensation in one or more alternative forms. Regulations adopted pursuant to the Internal Revenue Code and Social Security regulations likewise define salary reduction agreements to include employee elections to forego an increase in compensation. 26 CFR 1.403(b)-1; 26 CFR 32.1.

We do not suggest that the 1984 amendment was intended to follow internal revenue code rules defining salary. The 1984 amendment was clearly aimed at expanding the definition of "salary" for retirement purposes beyond the tax definition of salary. Nevertheless, we note that even for tax purposes,

salary reduction agreements are defined to include agreements whereby employees forego an increase in cash compensation.

In analyzing the language of the 1984 amendment, it is helpful to consider the policy behind the amendment and the reasonableness of alternative interpretations. As the Idaho Supreme Court has pointed out, statutes should be interpreted to give effect to legislative intent, and in determining legislative intent, it is appropriate to examine not only the language used, but also the reasonableness of the proposed interpretations and the policy behind a particular statute. Umphrey v. Sprinkel, 106 Idaho 700, 706, 682 P.2d 1247 (1983); Garcia v. Hanson, 101 Idaho 58, 608 P.2d 861 (1980). Thus, in addition to analysis of the reasonableness of alternative interpretations discussed above, a brief review of the circumstances surrounding this amendment may be helpful.

In 1983, PERSI observed that cafeteria plans, although beneficial to the participant for Internal Revenue Service purposes, had an adverse impact on both the Retirement System and the Retirement System members. This concern was expressed in a May 19, 1983, letter from Robert Venn, Executive Director of PERSI, to the Retirement System's actuarial firm, regarding possible legislative changes for 1984. In this letter, Mr. Venn states:

> Salary, 59-1302(31): There is evidence of an increasing interest in voluntary salary reduction plans as a scheme to shelter the tax liability for dependent group insurance premiums. Already implemented by some school districts, the plan encourages selection against the System by reducing income to the fund resulting from smaller contributions on reduced salary. However, members will elect to discontinue the voluntary salary reduction during their five-year salary base period to upset salary assumptions in your plan to fund the System.
>
> A solution would be to expand the salary definition by adding to the sentence: "... and also including the amount of any voluntary reduction made through agreement between the member and the employer."

The problems discussed in the letter resulted from the definition of salary (Idaho Code § 59-1302(31)) and from the way retirement contributions and benefits are calculated. Employer and employee contributions are calculated as a percentage of current salary. Idaho Code §§ 59-1304 and 59-1330. Retirement benefits, on the other hand, are based upon months of service and the employee's "average monthly salary." "Average monthly salary" is defined in Idaho Code § 59-1302(5A) to include only the highest salary during a consecutive 60-month base period. The base period is normally the five year period preceding retirement.

Before the 1984 amendment, an employee within a cafeteria plan could have elected tax-free fringe benefits during the early years of his or her career, thereby reducing retirement contributions. During the five-year period preceding retirement, the employee could elect cash compensation thereby increasing the "average monthly salary," the base upon which retirement benefits are calculated. As Mr. Venn's letter noted, such plans would encourage selection against the system by reducing income to the fund until the five-year base period thereby upsetting the actuarial assumptions (regarding contribution rates) necessary to fund system benefits.

In 1984, PERSI proposed and the legislature adopted the amendment to the definition of salary set forth above at page 2. The Statement of Purpose for this amendment states that the amendment:

> [P]revents adverse fiscal impact on either the Retirement Fund or a member's benefit entitlement in cases of voluntary salary reductions; ...

The Fiscal Impact Statement is similar:

> Prevents the adverse fiscal impact of certain member voluntary salary reduction elections.

The Senate and House State Affairs Committee minutes also reflect these same concerns. The March 5, 1984, Senate State Affairs Committee minutes note:

> Robert Venn, Director of the Public Employee Retirement System, explained this legislation prevents adverse fiscal impact on either the Retirement Fund or a member's benefit entitlement in cases of voluntary salary reductions; ...

The March 9, 1984, Senate Affairs Committee minutes note:

> Robert Venn, Director of the Public Employee Retirement System, explained the changes outlined in this legislation, stating they were mostly corrections in grammar, clarification of language, etc. Among other things covered by the bill are members who take voluntary salary reduction; ...

The March 23, 1984, House State Affairs Committee minutes note:

> Mr. Venn said that the bill redefines salary to include the voluntary salary reduction, ...

Finally, the Title to the 1984 Session Laws, Ch. 132 (S.B. 1363) reads:

> An Act relating to the Public Employee Retirement System of Idaho; Amending § 59-1302, Idaho Code, ... to expand the definition of "salary" to prevent inequities by changing circumstances, ...

The background and legislative history indicate that the amendment was aimed at avoiding adverse fiscal impacts upon the retirement fund and member benefits and preventing inequities between members. Our interpretation of the amendment furthers these purposes.

Employees with identical salary rights are treated identically for retirement purposes whether they elect to receive cash remuneration or alternative forms of remuneration. Both the contributions they make and the retirement benefits they receive will be the same. Thus, the interpretation above prevents inequities between members with identical salary rights.

The interpretation avoids adverse fiscal impacts on the retirement fund in those cases in which employees elect to receive fringe benefits during part of their work career and elect to receive cash during the five-year base period used to calculate retirement benefits. All members with the same years of service and same salary rights contribute an equal amount to the retirement fund based upon the amount of cash salary they have the option to receive. Likewise, the interpretation avoids adverse fiscal impacts upon member benefits in those instances in which members elect cash benefits during a portion of their work career but elect to receive alternative fringe benefits during the five-year base period used to calculate benefits. Again, all members with the same years of service and same salary rights receive the same retirement benefit.

Our interpretation of the section furthers the legislative purposes of the amendment. The alternative interpretation (that salary includes optional cash payments selected but not optional fringe benefits selected in lieu of cash) would create inequity between members with identical salary rights and cause adverse fiscal impacts on the retirement fund and member benefits.

It is our understanding that following the 1984 amendment, most, if not all, political subdivisions with cafeteria plans continued to remit retirement contributions only on taxable salary. On May 1, 1985, the executive director of the retirement system responded to several cafeteria plan questions raised by the Boise Education Association. In the letter, he advised that nontaxable employer-paid fringe benefits within cafeteria plans would fail the test for PERSI salary, whether used to pay insurance premiums or to provide cash to the employee. He qualified his advice, noting that it reflected his own analysis without having referred the questions to the Retirement Board. However, the letter was apparently distributed by the Boise Education Association to a number of school districts. On June 9, 1986, the retirement system attempted to correct the problem with a memorandum to all employers within the retirement system. The interpretation of "salary" in the June 9, 1986, memorandum is consistent with this opinion.

The courts give some deference to an administrative interpretation of a statute by an administrative agency which administers the law. Bashore v. Adopf, 41 Idaho 84, 238 P. 534 (1925); United Pacific Insurance Co. v. Bakes, 57 Idaho 537, 67

P.2d 1024 (1937). This does not limit an agency's right to change a prior administrative interpretation which it considers to be erroneous. Idaho Compensation Co. v. Hubbard, 70 Idaho 59, 62, 211 P.2d 413 (1949). Therefore, upon issuance of its June 9, 1986, memorandum to political subdivisions, the retirement system should properly insist upon compliance with the statute as interpreted in its memorandum and in this opinion.

In summary, cafeteria plan benefits should be included within the computation of salary to the extent the employee has a right to elect to receive cash benefits pursuant to the cafeteria plan. By doing so, both retirement benefits and contributions will be the same whether the employee elects to receive cash or alternative benefits with a corresponding reduction in cash received.

AUTHORITIES CONSIDERED:

Bashore v. Adopf, 41 Idaho 84, 238 P. 534 (1925)

Garcia v. Hanson, 101 Idaho 58, 608 P.2d 861 (1980)

Idaho Compensation Co. v. Hubbard, 70 Idaho 59, 62, 211 P.2d 413 (1949)

State, ex rel., Evans v. Click, 102 Idaho 443, 631 P.2d 614 (1981)

Umphrey v. Sprinkel, 106 Idaho 700, 706, 682 P.2d 1247 (1983)

United Pacific Insurance Co. v. Bakes, 57 Idaho 537, 67 P.2d 1024 (1937)

Idaho Code § 59-513

Idaho Code § 59-1302(5A)

Idaho Code § 59-1302(31)

Idaho Code § 59-1304

Idaho Code § 59-1330

1984 Sess.L., ch. 132 (S.B. 1363)

Internal Revenue Code § 61

Internal Revenue Code § 125(d)

Internal Revenue Code § 401(a)

Internal Revenue Code § 405(a)

26 USC §§ 1, et seq.

26 USC § 403(a)

26 CFR 1.403(b)-1

26 CFR 32.1

P.L. 95-615, § 5(e), 92 Stat. 3097 (Nov. 8, 1978)

DATED this 13th day of November, 1986.

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