

**THE BOARD OF TRUSTEES
OF THE PUBLIC SAFETY PERSONNEL RETIREMENT SYSTEM
OPINION 2010-01**

**Processing Disability Retirement Applications for PSPRS Members
Participating in the Deferred Retirement Option Plan**

I. BACKGROUND

The enabling legislation¹ of the Public Safety Personnel Retirement System (“System”) contains several statutes which set forth the provisions of the System’s Deferred Retirement Option Plan (“DROP”). The DROP statutes are found at A.R.S. §§ 38-844.02 to 38-844.09. DROP is an arrangement in which a System member eligible to retire continues working for a period that he irrevocably designates, up to a maximum of 60 consecutive months (the “DROP Period”). In exchange for the member’s continued service beyond his normal retirement date, the member and his employer are relieved of the obligation to make contributions to the member’s retirement, and the amount of retirement benefits that would otherwise be paid the member are deposited into an account (the “DROP Account”) maintained by the System, with such account earning interest at an annual rate equal to the System’s assumed earnings rate during each year of the member’s DROP Period. When the member retires at the end of the DROP Period, the amount in his DROP Account is paid to him in a lump sum. Thereafter, the member receives his normal retirement benefits every month as those benefits were calculated immediately prior to the commencement of the DROP Period (and as otherwise increased by cost of living adjustments).

DROP was instituted to prevent a so-called “brain drain” resulting from retirements:

[The program allows agencies] to retain senior, experienced workers who would otherwise retire after achieving high retirement incomes and therefore lowers recruiting and training expenses. Advocates also assert it saves government agencies money since they no longer have to contribute a percentage of the employee’s pay to the retirement system.

Arizona State Senate, Final Revised Fact Sheet for S.B. 1328, 2nd Reg. Session (2000).

Questions have arisen regarding the processing of accidental disability retirements during the DROP Period. An accidental disability is defined as “a physical or mental condition that the local board finds totally and permanently prevents an employee from performing a reasonable range of duties within the employee’s job classification and that was incurred in the performance of the employee’s duty.” A.R.S. § 38-842(1).

Specifically, there has been a marked increase in the number of applications for accidental disability pensions submitted shortly before conclusion of members’ DROP Periods.

¹ Arizona Revised Statutes (“A.R.S.”) §§ 38-841 to 38-860.

This increase in applications may be due to the fact that unlike normal retirement benefits, certain disability retirement payments may be tax free.² Cognizant of this distinction, some members participating in DROP are applying for accidental disability pensions before conclusion of their DROP Period *not* because their employment was actually terminated by reason of disability but, instead, simply as a mechanism to shield their retirement benefits from income tax.

Members who falsely claim that they have become disabled just before completion of the DROP Period place all other members and their participating employers, as well as the System, in jeopardy. Because the System is “qualified” as exempt from tax under the Internal Revenue Code, member and employer contributions to the System are not taxed until such time as the member retires and receives a pension. *See* 26 U.S.C. § 402(a). To maintain its “qualified” status, the System must comply strictly with the terms of its enabling legislation, and failure to do so may subject all employer and employee contributions, as well as all earnings of the System’s fund, to taxation. *See* 26 U.S.C. § 402(b). Thus, it is incumbent upon the local boards charged with administering the System for each participating employer (each, a “Local Board”) to ensure that each disability benefit application tendered by a member is legitimate and not a ruse merely to avoid tax.

Acutely aware of their administrative responsibilities, and concerned about a noticeable increase in accidental disability pensions tendered immediately before expiration of the DROP Period, two Local Boards have asked the System’s governing board for an official legal opinion about how to handle disability applications tendered during the DROP Period. This opinion is intended to address such inquiries and serve as the System’s official view on such matters.

II. SCENARIOS PRESENTED

Members participating in DROP may apply for disability benefits in the following scenarios:

1. A member participating in DROP files a disability application well before the member's designated completion date for the DROP Period.
2. A member participating in DROP files a disability application within a few months, weeks, or days before expiration of the member's DROP Period.
3. A member participating in DROP files a disability application after expiration of the member's DROP Period.

Before addressing each of these scenarios, we must examine the applicable statutory framework.

² A member who retires with an accidental disability with 20 years or less of service receives fifty percent of the member’s average monthly compensation, as of the time of the member’s termination of employment, tax free, thus effectively substantially increasing the value of his or her retirement. *See* 26 C.F.R. § 1.104-1(b). A member who retires with an accidental disability with more than 20 years of service receives a similar tax-free payment, plus a separate amount attributable to benefits earned after 20 years of service, that may be subject to income tax. *See id.*

II. STATUTORY FRAMEWORK

DROP was established “to add flexibility to the system and to provide members who elect to participate in the deferred retirement option plan access to a lump sum benefit in addition to their normal monthly retirement benefit on actual retirement.” *See* A.R.S. § 38-844.02(A). The eligibility requirements for DROP are set forth in A.R.S. § 38-844.03. A member who elects to participate in DROP must “voluntarily and irrevocably” designate a period of participation that does not exceed sixty consecutive months. A.R.S. § 38-844.03(B)(1).

A member who participates in DROP must “[a]gree to terminate employment on completion of the deferred retirement option plan participation period designated by the member on the appropriate deferred retirement option plan participation form.” *See* A.R.S. § 38-844.03(B)(5). Members who fail to terminate employment upon completion of the designated DROP Period face stiff financial penalties, in that they are “not entitled to the interest accumulation on the deferred retirement option plan participation account.” A.R.S. § 38-844.03(C)(1).

A.R.S. § 38-844.04(B) provides for the termination of DROP participation as follows:

Participation in the deferred retirement option plan terminates on the first occurrence of any of the following:

1. Completion of the deferred retirement option plan participation period designated by the member on the appropriate deferred retirement option plan participation form.
2. Termination of employment. If termination of employment for cause is reversed, a member's participation in the deferred retirement option plan, minus any benefits previously distributed pursuant to this article, shall be reinstated for the duration of the original deferred retirement option plan participation period designated by the member on the appropriate deferred retirement option plan participation form.
3. Death of the member.
4. Approval of disability retirement benefits pursuant to section 38-844, subsection B.

A.R.S. § 38-844.06(B) permits members in DROP to apply for disability benefits:

A member who elects to participate in the deferred retirement option plan and who becomes disabled during the period of deferred retirement option plan participation is eligible to apply for disability retirement benefits. If the application for disability retirement benefits is approved by the local board:

* * *

2. All amounts in the member's deferred retirement option plan participation account shall be distributed pursuant to section 38-844.08.

A.R.S. § 38-844.08(A) addresses the distribution of monies to members who complete DROP and thereby terminate employment:

On the simultaneous termination of deferred retirement option plan participation and employment, a member is entitled to receive both of the following:

1. The monthly retirement allowance in the amount determined pursuant to section 38-845 that was credited monthly to the member's deferred retirement option plan participation account at the date of termination of deferred retirement option plan participation.
2. All amounts credited to the member's deferred retirement option plan participation account on the effective date of termination of deferred retirement option plan participation.

A.R.S. § 38-844 lists the requirements for retirement benefits and disability pensions. Subsection B of the statute provides in relevant part:

A member is eligible for an accidental disability pension if the member's employment is terminated by reason of accidental disability. A member is eligible for an ordinary disability pension if the member's employment is terminated before the member's normal retirement date by reason of ordinary disability. A member shall file an application for a disability pension after the disabling incident or within one year after the date the member ceases to be an employee. Timely application for an accidental, catastrophic or ordinary disability pension is a prerequisite to receipt of the pension.

A.R.S. § 38-842(1) provides that “[a]ccidental disability’ means a physical or mental condition that the local board finds totally and permanently prevents an employee from performing a reasonable range of duties within the employee's job classification and that was incurred in the performance of the employee's duty.”

III. ANALYSIS

Local Boards have posed questions with respect to the relationship between A.R.S. § 38-844.06(B), which permits members in DROP to apply for accidental disability benefits, and A.R.S. § 38-844.04(B), which addresses termination of participation in DROP. A.R.S. § 38-844.06(B) provides that a member participating in DROP may apply for disability retirement benefits if the member becomes disabled during his DROP Period. A.R.S. § 38-844(B) requires

that the member's employment be “*terminated by reason of ... disability.*” (Emphasis added.) However, A.R.S. § 38-844.04(B) states that participation in the DROP terminates on the first occurrence of (1) the completion of the DROP Period, (2) termination of employment or (3) the *approval* of a disability retirement application.³

Scenario 1: A Member Participating In Drop Files A Disability Application Well Before Expiration Of The DROP Period.

When a member participating in DROP files a disability application well before the member completes his DROP Period, the Local Board should process the disability application in the normal course of the Board's business, taking into account whether, based on the applicable facts, the member's employment truly terminated by reason of accidental disability as opposed to some other reason. In this scenario, there will be ample time for the Local Board to review the application, determine whether an independent medical exam (“IME”) is required, schedule the IME, review the IME report, and determine whether to award a disability pension. See A.R.S. §§ 38-847 and 38-859 (duties and powers of local boards and medical boards).

Scenario 2: A Member Participating In Drop Files A Disability Application Near The End Of The DROP Period.

When a member participating in DROP applies for a disability retirement close to the end of the member's DROP Period, serious questions arise regarding what occurrence terminated the employment. The issue presented for resolution by the Local Board is whether the termination of employment results from the member's completion of the DROP Period, as provided in A.R.S. § 38-844.04(B)(1), or whether his employment has terminated as a result of accidental disability, thus making the member eligible for an accidental disability retirement pursuant to A.R.S. § 38-844(B).

Before exploring in more detail how to process accidental disability applications under Scenario 2, we need to dispel one ambiguity that has perplexed some Local Boards. Specifically, A.R.S. § 38-844.04(B) makes clear that employment terminates upon the *first* of the following events: completion of DROP, termination of employment, death, or the Local Board's approval of the disability retirement. If a member participating in DROP files an application for accidental disability benefits during his DROP Period, but the Local Board does not *approve* his disability application until *after* expiration of the DROP Period, can the member's employment ever be said to have terminated by reason of disability, as opposed to mere expiration of the DROP Period? We answer that query in the affirmative.

A.R.S. § 38-844.04(B) contemplates that a member can terminate employment for reasons *other than* completion of DROP *or* the Local Board's *approval* of a disability retirement. In our view, it is not necessary that a Local Board approve an accidental disability retirement application *before* the end of a member's DROP Period in order for the member to

³ The fourth possible event that would terminate participation in DROP is the member's death. Because the member's death is irrelevant to the discussion of this issue, we do not address it in this opinion.

qualify for an accidental disability pension because termination by reason of disability is included in the general event “termination of employment.”

Members participating in DROP who apply for accidental disability pensions prior to expiration of their DROP Periods are not precluded from seeking accidental disability benefits just because the Local Board considering their disability applications have not ruled on the application. Thus, the question then becomes how the Local Board should evaluate such applications in the event they are tendered just before expiration of the DROP Period. In our view, the relevant inquiry is the status of the member’s employment at the time that his DROP Period expired. If, upon expiration of the DROP Period, the member was not performing a full schedule of work (*i.e.*, he was on a reduced schedule or light duty) or was not working at all due to a documented disability (*i.e.*, he was on industrial leave as a result of his claimed disability), the Local Board may well find that the disability was the reason the member terminated employment, and approve the disability application. On the other hand, if, on the date the member was scheduled to complete DROP, the member worked a normal work day, then the member did not terminate employment by reason of disability, but instead, terminated employment because his DROP Period expired. If a member is not working immediately prior to expiration of this DROP Period because he is using remaining comp time or sick leave or other leave *unrelated to his claimed disability*, the Local Board should evaluate the member’s condition as of his last period of work.

Hosea v. City of Phoenix Fire Pension Board

The recent Arizona Court of Appeals opinion in *Hosea v. City of Phoenix Fire Pension Board*, __ P.3d __, WL1729216, Ariz.App.Div.1, April 29, 2010 (No. 1 CA-CV 09-0105)⁴ addressed a similar situation. In *Hosea*, a firefighter, William Hosea, entered DROP on April 17, 2002. Slip. Op. at ¶ 3. Mr. Hosea was injured on duty on July 9, 2006. *Id.* at ¶ 4. He did not apply for worker’s compensation benefits or seek medical attention through his employer’s health center, but instead used his own medical insurance when seeking treatment from two different physicians. *Id.* He was assigned to light duty, and used both sick and vacation leave to extend his time at work. *Id.* On May 17, 2007, he was finally examined at the City of Phoenix Fire Department Health Center, which released him to full duty. *Id.* at ¶ 5.

On May 27, 2007, one week after being released to full duty, Hosea filed an application for an accidental disability retirement with the City of Phoenix Fire Pension Board (“Fire Local Board”). *Id.* at ¶ 6. Hosea requested benefits arising from his injury on July 9, 2006, to be effective on May 31, 2007 – coincidentally the same date as the end of the DROP Period. *Id.* Hosea worked until the end of the DROP Period on full duty status as a firefighter. *Id.*

The Fire Local Board held a meeting on June 15, 2007, at which Hosea’s accidental disability retirement application was addressed. *Id.* at ¶ 7. The Fire Local Board declined to send Hosea to a medical board for an examination and denied his application because there was no “compelling evidence that [he] left the workforce because of his disability.” *Id.* (quoting the Fire Local Board minutes). Instead, the Fire Local Board granted Hosea a normal retirement benefit commencing June 1, 2007. *Id.* After rehearing the matter at Hosea’s request, the Fire

⁴ Motion for Reconsideration pending as of May 14, 2010.

Local Board upheld the earlier decision, finding that Hosea terminated “by virtue of [DROP]” and not because of his alleged disability. *Id.* (quoting the Fire Local Board minutes).

The issue on appeal was whether the Fire Local Board “violated the terms of the System by denying his application for accidental disability benefits without appointing a medical board,” which Hosea argued was an abuse of discretion, arbitrary and capricious, and contrary to law. *Id.* at ¶ 9. The Court agreed with the Fire Local Board that “medical evidence of the purported accidental disability is unnecessary when the alleged disability could not have been a cause of the member’s retirement.” *Id.* at ¶ 11. The Court held that the Fire Local Board denied Hosea’s application for an accidental disability retirement pension based upon “substantial evidence” that Hosea terminated employment because he had reached the end of his DROP Period. *Id.*

Importantly, the Court noted that Fire Local Board Member Brian Tobin had discussed the necessity of finding that Hosea had met the requirements for an accidental disability retirement pension, including a finding that “the reason for your termination of your employment must be the disability.” *Id.* at ¶ 15. The Fire Local Board members noted various factors that the Board considered in deciding not to appoint a medical board:

- Hosea did not seek workers’ compensation benefits for his injury;
- He took sick leave instead of industrial leave for the injury;
- He did not seek medical treatment from his employer’s health center at the time of the injury;
- His employer had no knowledge of his alleged inability to perform his duties;
- He worked the full 60 month DROP Period, except for time off on paid leave;
- “By his own admission,” Hosea continued working as long as he could because he had an end date – the end of the DROP Period – by which he planned to retire; and
- Hosea was on full status duty as a fire fighter on his last day of the DROP Period.

Id. at ¶¶ 17-19. Thus, the Court found that the Fire Local Board was not required to appoint a medical board because Hosea “did not meet the threshold statutory eligibility requirement” for an accidental disability retirement pension. *Id.* at ¶ 30.

The factors considered by the Fire Local Board in the *Hosea* case are examples of the type of factors that Local Boards should consider in determining whether a member is terminating his employment due to an accidental disability or due to the end of his DROP Period.

Scenario 3: A Member Participating In DROP Files A Disability Application After Expiration Of His DROP Period.

A.R.S. § 38-844(B) permits a member to file a disability application up to one year after cessation of employment. While this essentially permits a member who completed his DROP Period to file an application for disability retirement up to a year after his cessation of employment, such belated disability applications beg the question whether the member’s employment truly was terminated by reason of accidental disability as opposed to expiration of his DROP Period. We think the proper analysis should focus on the status of the member’s employment at the time his

DROP Period expired. If, on the date the member was scheduled to complete his DROP Period, the member was not working a full schedule of work (*i.e.*, he was on a reduced schedule or light duty) or was not working at all due to a documented disability (*i.e.*, he was on industrial leave due to such disability), and the member has applied for a disability retirement after completion of his DROP Period, then it can be argued that the disability caused the member to terminate employment. Conversely, if on the date the member was scheduled to complete his DROP Period, the member worked a normal work day, then the member could not reasonably be said to have terminated his employment by reason of disability. Instead, he terminated employment because his DROP Period expired. If a member is not working immediately prior to expiration of this DROP Period because he is using remaining comp time or sick leave or other leave unrelated to his claimed disability, the Local Board should evaluate the member's condition as of his last period of work.

IV. CONCLUSION

When a member participating in DROP applies for disability retirement, whether such application is long before, on the eve, or even after the expiration of the member's DROP Period, the focus of the Local Board's inquiry should be whether the member's employment was actually terminated by reason of accidental disability as opposed to some other reason, including expiration of his DROP Period. In most cases, the analysis should center on the member's final day of employment.

If the facts show that, on the date the member was scheduled to complete his DROP Period, the member was not working a full schedule of work (*i.e.*, he was on a reduced schedule or light duty) or was not working at all due to a documented disability (*i.e.*, he was on industrial leave due to such disability), then the Local Board may (but is not required to) conclude that the member terminated employment due to accidental disability.

Conversely, if on the date the member was scheduled to complete his DROP Period, the member worked a normal work day, then the member could not reasonably be said to have terminated his employment by reason of disability. Instead, he terminated employment because his DROP Period expired. If a member is not working immediately prior to expiration of this DROP Period because he is using remaining comp time or sick leave or other leave ***unrelated to his claimed disability***, the Local Board should evaluate the member's condition as of his last period of work.