



The Texas A&M University System

Office of General Counsel

John B. Connally Building, 6th Floor • 301 Tarrow • College Station, Texas 77840-7896
Phone (979) 458-6120 • Fax (979) 845-9750 • Campus Mailstop 1230 • <http://sago.tamu.edu/legal>

June 22, 2001

RQ-0396-JC

RECEIVED
JUN 26 2001
OPINION COMMITTEE

The Honorable John Cornyn
Attorney General of Texas
P. O. Box 12548
Austin, Texas 78711-2548

RE: Nonqualified Compensation Option Plan

FILE # ML-42049-01
I.D. # 42049

Dear General Cornyn:

The Texas A&M University System (the "System") is requesting an Attorney General Opinion as to whether the System may offer some employees the opportunity to participate in an employer-sponsored program described by §457(f) of the Internal Revenue Code of 1986, including that portion of any plan which consists of a transfer of property described in §83 of the Internal Revenue Code of 1986, including subsequent amendments of that law. We believe that Texas Pensions Code, Tex. Rev. Civ. Stat. Ann. art. 6228a-5, §3(a) authorizes the Board of Regents of the System to implement such an employer-sponsored program.

Background

Texas Pensions Code, Article 6228a-5, §3(a)

Tex. Rev. Civ. Stat. Ann. art. 6228a-5, §3(a) states that "A state agency may permit some or all of the employees of the agency to participate in an employer-sponsored program described by §457(f) of the Internal Revenue Code of 1986, including subsequent amendments of that law."

IRC §457(f)

IRC §457(f) provides for the tax treatment of participants in employment plans offered by the employer which are not eligible deferral plans under §457. The statute states:

"(1) In general. In the case of a plan of an eligible employer providing for a deferral of compensation, if such plan is not an eligible deferred compensation plan, then—

Universities

Prairie View A&M University • Tarleton State University • Texas A&M International University • Texas A&M University • Texas A&M University-Commerce • Texas A&M University-Corpus Christi
Texas A&M University-Kingsville • Texas A&M University-Texarkana • West Texas A&M University

Agencies

Texas Agricultural Experiment Station • Texas Agricultural Extension Service • Texas Engineering Experiment Station • Texas Engineering Extension Service • Texas Forest Service
Texas Transportation Institute • Texas Veterinary Medical Diagnostic Laboratory • Texas Wildlife Damage Management Service

(A) the compensation shall be included in the gross income of the participant beneficiary for the 1st taxable year in which there is no substantial risk of forfeiture of the rights to such compensation.”

Paragraph §457(f)(2) then goes on to state the exceptions to situations in which paragraph (1) does not apply as follows:

“Exceptions. Paragraph (1) shall not apply to— . . . (C) that portion of any plan which consists of a transfer of property described in section 83 . . .”

IRC §83

IRC §83 provides that:

Property transferred in connection with performance of services.

(a) General Rule: If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of--(1) the fair market value of such property . . . at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Section 83(b) provides for the election as follows:

(b) Election to include in gross income in year of transfer.

(1) In general. Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income, for the taxable year in which such property is transferred, the excess of—

- (A) the fair market value of such property at the time of transfer . . . over
- (B) the amount (if any) paid for such property.

If such election is made subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

Discussion

Federal income tax is assessed on income based on its characterization by the State in which the income is earned or originates. Therefore, appropriate authority must be found in State law. Other deferral programs utilized by the System are authorized by the Texas Pension Code, Tex. Rev. Civ. Stat. Ann. art. 6228a-5, §2(b). More specifically, Government Code §822.201 authorizes the TRS under IRC §401(a) and Government Code §830.002 authorizes the ORP under IRC §403(b).

A section §83(a) plan is not a deduction. *Cf.* TEX. GOV'T CODE ANN. §659.002(a) (deduction from compensation must be authorized by law). It is not a deduction because the employee does not have the option of taking the compensation immediately, or for that matter, he or she may never be in a position to receive the income. Hence, it is not deducted because it would not have been paid at that point in time.

The ability of an individual to participate in the deferral advantages gained through §83(a) reflect the actual underlying rights in the contract. For example, the contract may provide that the employee does not have the right to acquire the shares until he or she has worked a certain period of time. Therefore, the result would be the same as any standard compensation contract afforded to an employee; the income would not be taxed until actually vested or earned. Similarly, in the case of a §83(b) election where the taxpayer elects to recognize income at the grant date but at an anticipated much lower value than at the anticipated future exercise date, the taxpayer would have no right to a deduction in subsequent years if the employee did not complete the vesting period and lost the exercise right.

In reviewing the authority of a state university system to offer prepaid legal services coverage as part of an IRC §125 cafeteria plan, the Attorney General determined that the university system's authority was as broad as the federal authorization. "The governing board may include in a cafeteria plan any benefit that may be included in a cafeteria plan under federal law." TEX. INS. CODE ANN. Art. 3.50-3, §4(e) (Vernon Supp. 2001). If prepaid legal services coverage could be offered as part of a cafeteria plan pursuant to federal law, it could be offered by the university system. Tex. Att'y Gen. LO-92-41(1992).

We believe that just as prepaid legal services coverage was authorized by Insurance Code Art. 3.50-3, §4(e) to the extent federal law authorized prepaid legal services coverage, Tex. Rev. Civ. Stat. Ann. art. 6228a-5, §3(a) authorizes an IRC §457(f) plan that includes elements that qualify for IRC §83 treatment. IRC 457(f) specifically contemplates a plan that includes elements that qualify for IRC §83 treatment, ". . . that portion of any plan which consists of a transfer of property described in Section 83." 26 USC §457(f)(2)(C)(exempting that portion of a plan that qualifies under §83 from the substantial risk of forfeiture requirements otherwise applicable to a §457(f) plan).

The Honorable John Cornyn
June 22, 2001
Page 4

Therefore, we believe Tex. Rev. Civ. Stat. Ann. art. 6228a-5, §3(a) authorizes the Board of Regents to implement an employer-sponsored program described by IRC §457(f), including that portion of any plan which consists of a transfer of property described in IRC §83.

Your consideration of this request is greatly appreciated.

Sincerely,


Delmar L. Cain
General Counsel