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Legal Opinion L-2005-25
December 2, 2005

TO: Joseph Ellena
Chief of Audit and Compliance
Bureau of Fiscal Operations

FROM: Steven A. Bartholow
General Counsel

SUBJECT: Qualified and Non-Qualified Stock Options
Compensation under the Railroad Retirement Act
and Railroad Retirement Tax Act

This is in reply to your request for clarification as to when a stock option results in compensation to the employee under the Railroad Retirement Act (RRA) and the Railroad Unemployment Insurance Act(RUIA), in view of the amendment to the Railroad Retirement Tax Act (RRTA) made by the American Jobs Creation Act of 2004 (Public Law 108-357). As explained below, I agree with your interpretation, based on the preliminary advice provided earlier by my staff, that only a "qualified" stock option is excluded from taxable compensation under the RRTA and from creditable compensation under the RRA. Moreover, in my opinion, qualified stock options did not result in creditable compensation prior to enactment of P.L. 108-357 as well. However, it is also my opinion that an employee receives compensation for purposes of the RRA when receiving stock transferred pursuant to a "non-qualified" stock option.

As you know, section 1(h)(1) of the RRA defines compensation for benefit entitlement purposes under that Act in part as "any form of money remuneration paid to an individual for services rendered as an employee to one or more [railroad] employers". Section 211.2(a) of the Board's regulations further defines compensation to include remuneration not paid in cash:

> (a)The term compensation means any form of payment made to an individual for services rendered as an employee for an employer * * *. Compensation may be paid as money, a commodity, a service or a privilege. However, if an employee is to be paid in any form other than money, the employer and the employee must agree before the service is performed upon the following:
>
> (1) The value of the commodity, service or privilege; and
> (2) That the amount agreed upon to be paid may be paid in the form of the commodity, service or privilege.

The RUIA provides a substantially identical definition. See RUIA section 1(i)(1); see also, regulations of the Board under the RUIA at 20 CFR 322.2(a).

Section 1(h)(6) of the RRA lists six exclusions from the general definition of compensation: tips; earnings by certain non-resident aliens; local union lodge compensation less than $25; compensation for certain union delegates; payments under employer sickness and disability plans; and employer reimbursements for bona fide employee expenses. See also, regulations of the Board at 20 CFR 211.2(c).

A general definition of compensation paralleling RRA sections 1(h)(1) and 1(h)(6) above is also found at section 3231(e)(1) of the RRTA (26 U.S.C. §3231(e)(1)). However, beginning with paragraph 3231(e)(4) the RRTA lists additional exclusions from taxable compensation. Paragraph 3231(e)(12), added by section 251(a)(2) of P.L. 108-357 (118 Stat. 1458, 1473) provides:

> (12) Qualified Stock Options.—The term "compensation" shall not include

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any remuneration on account of—

(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or
(B) any disposition by the individual of such stock.

This Office has long recognized that in view of the substantial similarity between the definitions of compensation under the RRA and RRTA, it is desirable, absent controlling language to the contrary, to treat payments to employees by employers in the same fashion under both statutes. See Legal Opinions L-82-176, (conforming crediting of compensation under the RRA to taxation under the RRTA of distributions from a Productivity Trust Fund); and L-90-30 (exclusion of the value of meals and lodging). The amendment to the RRTA by P.L. 108-357, without a similar amendment to the definition of compensation under the RRA, raises the question as to whether the transfer to, or subsequent disposition by the employee of stock from the employer pursuant to a stock option should be considered compensation for benefit entitlement purposes under the RRA.

To provide advice regarding treatment of stock options as compensation under the RRA, it is necessary to consider the Internal Revenue Code (IRC) provisions relating to stock options, including sections 422 and 423 mentioned in new section 3231(e)(12). It is also helpful to summarize requirements for qualified and non-qualified stock options in order to distinguish between them for purposes of determining creditability as compensation under the RRA and RUIA. I must note however, that the following discussion of IRC provisions in this memorandum cannot be relied upon as guidance in tax preparation. Guidance on issues arising under the IRC must be obtained from the Internal Revenue Service.

I. Qualified Stock Options as Income.

Under the IRC, the terms “qualified” and “non-qualified” stock options refer to whether a transfer of stock qualifies for favorable income tax treatment under section 421 of the Internal Revenue Code (IRC) (26 U.S.C. § 421). Regulations of the Internal Revenue Service define a stock option for purposes of section 421 as an agreement between the employer and employee to allow the employee to purchase shares of the employer at a fixed price on a fixed date, or within a range of dates. See 26 CFR 1.421-7(a)(1). A “qualified” stock option meets the requirements for either an “Incentive Stock Option” (ISO) under IRC section 422, or for an “Employee Stock Purchase Plan” (ESPP) under IRC section 423.
26 U.S.C. §§ 422, 423. Because the requirements for qualification are statutory, qualified stock options are also referred to as “statutory” stock options; stock options which do not qualify are “non-statutory”.

Some statutory requirements apply to both Incentive Stock Option Plans and Employee Stock Purchase Plans. Both must be offered to employees under plans approved by the shareholders which offer shares in the employer, its subsidiary, or its parent corporation. Both must be exercised only by the employee unless the right passes by will or law to the employee’s estate at death. Both must be determined to qualify at the time when the employer grants the option, rather than when the option is exercised or when the stock is sold. Neither may be offered to employees owning voting power exceeding stated limits (10% for ISOs, 5% for ESPPs). See: 26 CFR 1.421-1(b); see also, 26 U.S.C. § 422(b) and 26 CFR 1.422-2(b) (for ISOs); and 26 U.S.C. § 423(b) (for ESPPs).

Other requirements are specific to each type of plan. An Incentive Stock Option may be offered for any reason connected with the individual’s employment. ISO plans must set out the number of shares that may be issued as options, and the employees or classes of employees who may receive the options. An ISO must be granted within 10 years of the date the plan itself is approved or adopted, and cannot be exercised more than 10 years from the date the option is granted. The option price must be at least the fair market value of the stock at the time the option is granted. See IRC section 422(b)

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Employee Stock Purchase plans must be in writing and offered to all employees, other than those employed less than 2 years, those employed part-time, or those who are "highly compensated" as defined by section 414(q) of the Code. All employees must be granted the same rights. An employee cannot be granted the option to purchase more than $25,000 in stock per calendar year. The price offered the employee must be at least the lower of 85% of the fair market value of the stock either at the time the option is granted or exercised. Purchase options under ESPPs must be exercised no later than 5 years from the date the option is granted if the option price is at least 85% of fair market value at time of exercise of the option; otherwise stock must be purchased within 27 months of date the option is granted. See IRC section 423(b) (26 U.S.C. § 423(b)).

If a plan qualifies as an ISO or an ESPP, the employee is not considered to have received taxable income at either the time the option is granted, or at the time the employee exercises the option and buys the stock. Other rules specify taxation when the employee disposes of the stock, or when the employee fails to hold the stock for specified minimum periods, but are not relevant to this discussion.

II. Non-Qualified Stock Options as Income

A stock option not qualifying under section 422 or 423 is considered a transfer of property in connection with service performed for the employer within the meaning of section 83 of the IRC (26 U.S.C. § 83). Under that section a stock option results in income to the employee either at the time the employer grants the option to purchase to the employee, or at the time the employee sells the stock. The point in time depends upon whether the option itself has a readily ascertainable fair market value at the date the option is granted, derived from active trading of the option on an established market. See IRS regulations at 26 CFR 1.83-7(b)(1).

If the option has an ascertainable fair market value at the time it is granted, the employee must include the value of the option as income at that time, less any amount the employee has paid for the option. 26 CFR 1.83-7(a) The option must also be either transferable, or not subject to substantial risk of forfeiture, as defined by section 83(c)(1), and IRS regulations at 26 CFR 1.83-3(c)(1).

If the option does not have a readily ascertainable fair market value at time of grant, then the employee receives income when the option to purchase is exercised, or is transferred to another, unless the employee's rights to the stock are not substantially vested. See IRC section 83(a). The amount of income to the employee is the fair market value of the stock at time of transfer, less any amount the employee paid. If the employee's rights to stock purchased under the option are not fully vested at the time the stock is transferred, then the employee receives income in the year the stock is free of substantial risk of forfeiture or may be transferred free of risk. See 26 CFR 1.83-3(c)(1).

III. Stock Options as Wages under the Social Security Act

Section 209(a) of the Social Security Act (42 U.S.C. § 409(a)), which defines "wages" for benefit entitlement purposes under the SSA as remuneration for employment "including the cash value of all remuneration (including benefits) paid in any medium other than cash", is analogous to RRA section 1(h). The Social Security Administration has not issued any regulations on the treatment of stock options as wages for purposes of section 209, and I am unable to locate any administrative ruling on the question. However, the law and administrative rulings relating to treatment of stock options as wages under the parallel FICA section (26 U.S.C. § 3121(a)) are clear.

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Initially, the IRS has determined that non-qualified transfers of stock from employer to employee are "remuneration paid in items other than cash" under section 3121(a) of the Code, and the regulations promulgated thereunder at 26 CFR 31.3121(a)-1(e). See Rev. Rul. 78-185, 1978-1 Cum. Bul. 304. The amount determined to be wages is the excess of the fair market value of the stock on the date of transfer, less any employee contribution. Id., at 305. This advice, which was consistent with the Supreme Court decision in Commissioner v. LoBue, 351 U.S. 243 (1956), has never been withdrawn.

Earlier in the 1970s, the IRS also issued a ruling regarding stock transfers under qualified stock options. See Rev. Rul 71-52, 1971-1 Cum. Bul. 278. Unlike non-qualified options, the IRS determined in the 1971 ruling that under qualified stock options, neither the employee's exercise of an option to purchase stock, nor the later disposition of the shares, resulted in the employee's receipt of wages under FICA. Also unlike the advice regarding non-qualified stock options, though, the IRS notified the public in 1987 that an amendment to IRC section 3121(a) by section 327 of the Social Security Amendments of 1983 (P.L. 98-21, 97 Stat. 65 at 126-127), caused the IRS to reconsider the conclusion in Rev. Rul. 71-52. See Notice No. 87-49, 1987-2 Cum. Bul. 355.

Subsequently, the IRS proposed to add new section 31.3121(a)-1(k) to its regulations, stating that exercise of a qualified stock option effective January 2003 would result in wages to the employee in same manner as non-qualified stock options. See: Application of the Federal Insurance Contributions Act, Federal Unemployment Tax Act, and Collection of Income Tax at the Source to Statutory Stock Options, 66 Fed. Reg. 57023, 57027. (November 14, 2001). The IRS explained that it considered these stock transfers as wages subject to FICA because excluding the value of stock transferred under a qualified stock option from income did not alter its compensatory character for employment tax purposes. 66 Fed. Reg. at 57025. On June 25, 2002, the IRS notified the public that it had suspended action on the question, pending review of the comments received on the proposed regulations. See Notice 2002-47, 2002-2 Cum. Bul. 97. No final regulation had yet been issued when Congress amended both FICA and the Social Security Act to specifically exclude stock transferred under an ISO or ESPP from the definition of wages. P. L. 108-357 § 251(a)(1),(118 Stat. at 1458). In effect, these amendments validated the interpretation of IRS prior to the 1987 announcement.

IV. Stock Options as Compensation under the RRA

I am not aware of any ruling by the IRS directly addressing treatment of the various stock options as compensation for purposes of RRTA section 3231(e). However, regulations promulgated by the IRS under section 3231(e) provide that compensation for RRTA purposes has the same meaning as wages under FICA section 3121(a), except as specifically limited by the RRTA or by regulation. See 26 CFR 31.3231(e)-1(a).

Applying section 31.3231(e)-1(a) to non-qualified stock options indicates the IRS would consider transfers of stock under this category of options to be compensation under the RRTA. No RRTA provision specifically excludes the value of stock transferred under a non-qualified stock option from the definition of compensation. Revenue Ruling 78-185 held that the value of stock transferred becomes wages under FICA. Under section 31.3231(e) of the IRS regulations, the transfer of stock under a non-qualified stock option therefore results in compensation to the employee under the RRTA as well. Compensation is paid at the time stock is transferred under a non-qualified stock option, or at the time the employee has no substantial risk of forfeiture, if later. The amount of compensation is the fair market value of the stock at that time, less any contribution toward purchase by the employee, as determined under IRC section 83(a). The Board's policy to apply the RRA as the RRTA would be in like circumstances, in my opinion, requires that non-qualifying stock options result in compensation creditable under RRA section 1(h)(1) as well. Compensation would also be creditable under section 1(k) of the RUIA.

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Prior to the 2004 amendment to the RRTA, section 31.3231(e) of the IRS regulations also indicates that the IRS would exclude transfers under qualifying stock options from compensation under the RRTA on the basis of the analysis which Revenue Ruling 71-52 applied under FICA. Consistent interpretation under the RRA would require that acquisition or disposition of stock under a qualified stock option prior to October 22, 2004, be excluded from creditable compensation on that basis as well. Moreover, no compensation would be creditable for stock received under qualified stock options under section 1(k) of the RUIA.

In addition, amendment of the RRTA effective October 22, 2004, by P.L. 108-357 without a comparable amendment to the RRA does not indicate Congress intended that these transactions should now result in creditable compensation under the RRA. The simultaneous amendments to the SSA and to FICA by P.L. 108-357 show Congress' general intent that the benefit wage base should follow the tax wage base. The simultaneous amendment to the RRTA shows Congress' intent that the railroad retirement system should follow the social security system in that respect as well. I note that when the Social Security Amendments of 1983 added section 3121(a)(19) to FICA without a parallel change in the RRTA, Congress corrected the omission in 1989. See: Public Law 101-239 § 10207(a) (103 Stat. 2106 at 2476), which added RRTA paragraph 3231(e)(10). In Legal Opinion L-90-30, I advised that the employee expenses excluded from taxable compensation by 3231(e)(10) should be excluded from compensation creditable under RRA section 1(h)(1). In effect, L-90-30 read a benefit compensation base amendment for the RRA into P.L. 101-239 because Congress had earlier enacted such an amendment to the SSA at the time FICA was amended by the 1983 Act. The link between benefit base and tax base is even stronger between provisions which amended all three statutes together in P.L. 108-357, than it was between provisions in statutes enacted separately in 1983 and 1989.

Accordingly, in my opinion transfer of employer stock to employees under qualifying stock options, and subsequent disposition of the stock by the employee, does not result in compensation to that employee under the RRA and the RUIA, either before or after October 22, 2004, the effective date of new section 3231(e)(12) of the RRTA.