

ISO Spread Income Held to be "Wages"

by Robert W. Wood • San Francisco

Incentive Stock Options or ISOs have varied in popularity. In certain industries, of course, particularly high-tech fields, it is difficult to attract talent without fairly generous option plans. One such plan involving Sun Microsystems was recently reviewed by the Tax Court. See *Sun Microsystems, Inc., et al v. Commissioner*, T.C. Memo 1995-69 (1995).

The Sun Microsystems ISO plan granted ISOs to various employees between 1983 and 1986. Options were exercised between 1985 and 1987. During 1987, ISO shares acquired by employees were sold by the employees before the expiration of the holding periods specified in Section 422A(a). These sales were "disqualifying dispositions" under Section 421(b), thus tainting the employees with income equal to the difference between the fair market value of the shares on the exercise date and the amount paid for the shares. This so-called "spread income" wound up on the employees' Forms W-2. In fact, the spread income was lumped in with the other compensation received by the employees.

Sun Microsystems withheld taxes on the spread income only when the ISO was exercised and the stock was sold on the same day. Sun did not, however, withhold when the stock was sold after the exercise date. Once the IRS issued Notice 87-49, 1987-2 C.B. 355, Sun Microsystems discontinued withholding of taxes even on same-day sales. Notice 87-49 had concluded that spread income did not constitute wages for purposes of withholding, even though the spread income was obviously includable in the employees' income.

Is It Wages or Isn't It?

For 1987, Sun Microsystems claimed a credit for increasing research activities under Section 41. In so doing, it included the spread income from disqualifying dispositions as wages. The IRS disagreed, reducing the qualifying research expenses by the amount of the spread income, correspondingly reducing the amount of the research credit.

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The Tax Court has now held that the ISO spread income does constitute wages for purposes of Section 41. Referring to the broad definition of "qualified research expenses," the court noted that the term includes wages paid or incurred to an employee for qualified services.

The Tax Court likewise looked at the definition of "wages" under Section 3401(a), a provision that is designed to apply to all compensatory payments, whether or not paid in cash. Noting the wide net that Section 3401 casts for all remuneration whether or not paid in the medium of cash, the court found that the spread income increment of value represented by the disqualifying disposition was indeed wages.

The Tax Court specifically rejected the IRS positions set forth in Notice 87-49, and the earlier position in Revenue Ruling 71-52, 1971-1 C.B. 278. That earlier ruling had also taken the position that spread income was not wages. The court simply determined that the Service was wrong, and that these revenue rulings were not binding on the court.

Nonqualified Options, Too

The Tax Court looked favorably on its decision in *Apple Computer, Inc. v. Commissioner*, 98 T.C. 232 (1992). There, the Tax Court held that the spread income resulting from the exercise of a nonqualified stock option qualified as wages under Section 3401(a), and was therefore also wages for purposes of research credit under Section 41's predecessor. The *Sun Microsystems* case was an extension to the ISO field of the decision in *Apple Computer*. ■