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Nov. 4,

ACTION ON DECISION

Subject: Sun Microsystems, Inc. v. Commissioner
T.C.M. 1995-69
T.C. Dkt. No. 8976-91

Issue:

Whether the spread income realized from a disqualifying disposition of stock purchased through the taxpayer's incentive stock option ("ISO") plan constitutes wages under section 41(b)(2)(D) in determining whether certain qualified research expenses qualify for the credit for increasing research activities under section 41.

Discussion:

Under the taxpayer's ISO plan, employees engaged in qualified services from April 1983 to July 1986 were granted ISOs meeting the requirements of former section 422A of the Code. During the 1987 tax year, the taxpayer's employees sold shares of stock they had acquired through the exercise of ISOs before the expiration of the holding periods under section 422A. These "disqualifying dispositions" under section 421(b) generated income to the taxpayer's employees equal to the difference between the fair market value of the shares on the exercise date and the amount paid for the shares ("spread income"). The taxpayer claimed a credit for increasing research activities under section 41 on its 1987 return, including as "wages" the spread income attributable to the disqualifying dispositions of ISO stock. The Service issued a notice of deficiency, proposing to reduce the taxpayer's qualified research expenses by the income attributable to the disqualifying dispositions, thereby reducing the taxpayer's credit for increasing research activities under section 41 for 1987.

Under section 41(b)(2)(D), wages--a research expense used in calculating the research credit--means the same as wages under section 3401(a). Relying on Rev. Rul. 71-52, 1971-1 C.B. 278, the Service argued that the spread income from disqualifying dispositions of ISO stock was not wages under section 3401. In Rev. Rul. 71-52, the Service ruled that

spread income attributable to disqualifying dispositions of stock purchased under a qualified stock option plan was ordinary income but not wages requiring a corporation to withhold employment taxes (although the Service later announced it was reconsidering this position in Notice 87-49, 1987-2 C.B. 355). The Tax Court rejected the Service's argument, relying on Apple Computer, Inc. v. Commissioner, 98 T.C. 232 (1992), acq., 1992-2 C.B. 1. In Apple Computer, Inc., the court held that the spread income attributable to the exercise of a nonqualified stock option was wages under section 3401(a) and, therefore, wages under section 41 for purposes of the research credit.

Finding neither support for the Service's position in Rev. Rul. 71-52, nor a basis for distinguishing Apple Computer, Inc., the court held that the spread income attributable to disqualifying dispositions of ISO stock constitutes wages for determining the credit for increasing research activities under section 41.

Recommendation:

Acquiescence.

Reviewers:

JEA
MEO
SHI

/s/

JAMES L. EGGEMAN
Attorney

Approved: STUART L. BROWN
Chief Counsel

/s/

By:

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