Apple Computer, Inc. v. Commissioner, 98 T. C. 232 (1992)

Stock option spreads are wages that can be included in the calculation of the research tax credit under section 44F of the Internal Revenue Code.

Summary

Apple Computer, Inc. sought to include stock option spreads in their calculation of the research tax credit under section 44F of the Internal Revenue Code. The spreads were treated as wages for employees exercising nonstatutory stock options. The Tax Court held that these spreads constituted wages paid for qualified services, were incurred expenses under the accrual method of accounting, and were eligible for the credit even if the options were granted before the enactment of section 44F. The decision clarified the scope of the research tax credit, allowing companies to utilize stock option spreads as part of their qualified research expenses.

Facts

Apple Computer, Inc. maintained three employee stock option plans, granting options between 1978 and 1980. The options vested over four years and were exercised by employees paying the option price. The spreads (the difference between the fair market value at exercise and the option price) were treated as wages by Apple. These spreads were significant, with increases in stock value ranging from 7,467% to 28,933% for many options. Apple claimed these spreads as wages for the research tax credit under section 44F, which the Commissioner disallowed, asserting they were not wages for credit purposes.

Procedural History

The Commissioner determined deficiencies in Apple's consolidated income tax for fiscal years 1981-1983. Both parties filed cross-motions for partial summary judgment in the U. S. Tax Court, which granted Apple's motion, allowing the spreads to be included in the credit calculation.

Issue(s)

1. Whether the spreads generated upon the exercise of nonstatutory stock options constitute wages under section 44F(b)(2)(A)(i)?
2. Whether Apple paid or incurred the spreads?
3. Whether expenses incurred in a year after the year in which services were performed qualify for the credit?
4. Whether the spreads arising from options granted before the enactment of section 44F qualify for the credit?

Holding

1. Yes, because the spreads are wages under section 3401(a) and thus qualify as

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wages under section 44F(b)(2)(A)(i).
2. Yes, because Apple incurred a liability when each option was exercised under the accrual method of accounting.
3. Yes, because the statute does not require expenses to be paid or incurred in the year the services were performed.
4. Yes, because the expenses were incurred after the effective date of section 44F, when the options were exercised.

Court's Reasoning

The court applied the statutory definition of wages from section 3401(a) to section 44F, concluding that spreads were wages. The court rejected the Commissioner's argument that Congress did not intend to include spreads, citing the legislative history and prior tax law under section 83. The court also determined that Apple incurred expenses when options were exercised, consistent with the accrual method of accounting and IRS rulings. The court found no statutory or legislative basis to restrict the credit to expenses paid or incurred in the year of service performance. Lastly, the court ruled that the effective date of section 44F allowed for the inclusion of spreads from pre-enactment options, as long as they were exercised post-enactment.

Practical Implications

This decision impacts how companies calculate the research tax credit, allowing the inclusion of stock option spreads as wages. It clarifies that the timing of when expenses are incurred under the accrual method can qualify them for the credit, regardless of when the services were performed. The ruling may encourage companies to use stock options as part of compensation for research activities, knowing that the spreads can be utilized in tax credit calculations. Subsequent cases and IRS guidance have referenced this decision when addressing the treatment of stock options in tax credit calculations.

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