Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Deductibility of Statutory Stock Options under § 174

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Amount 1:
Amount 2:
Amount 3:
Amount 4:
Amount 5:
Amount 6:
Amount 7:

Business 1:

Corporation 1:

Date 1:

Product 1:

Product 2:

Product 3:

Target:

Year 1:
Year 2:
Year 3:
Year 4:
Year 5:
Year 6:
Year 7:

ISSUE

Whether Corporation 1 may claim a deduction under § 174[1] for statutory stock options that were exercised by employees working on research and development ("R&D")?

CONCLUSIONS

No. Corporation 1 may not claim a deduction under § 174 for exercised statutory stock options. In light of § 174's legislative history, the claimed deductions should not qualify as "research or experimental expenditures" under § 174. Furthermore, § 421 does not permit a deduction for exercised statutory stock options under § 174.

FACTS

Corporation 1 is a Business 1 company. It develops, manufactures, markets, distributes and services Product 1. Corporation 1 also offers a Product 2. Corporation 1 is an accrual method taxpayer. In Date 1, Corporation 1 completed the acquisition of Target, a provider of Product 3, for approximately Amount 1.

Target granted § 422 incentive stock options ("ISOs") and offered a § 423 employee stock purchase plan ("ESPP") to its employees, including employees performing R&D. A number of these R&D employees exercised their ISOs or purchased stock pursuant to the ESPP during the taxable years Year 1, Year 2 and Year 3. Unless there was a disqualifying disposition under § 421(b), Target did not claim a deduction for the exercise of these ISOs and ESPP purchases by its R&D employees.

For the tax years Year 1, Year 2, and Year 3, Corporation 1 has now claimed deductions under § 174 for the Target ISOs and ESPP options exercised by employees who performed or were otherwise involved in R&D. The amounts of these claims are as follows:

Year 1	Amount 2

[1] All section references are to the Internal Revenue Code of 1986, as amended.

Year 2	Amount 3
Year 3	Amount 4

Corporation 1 has informed the Exam Team that it anticipates making claims on behalf of Target for Year 4 and Year 5. These claimed deductions are based on the difference (the "Spread") between the exercise price and the fair market value of the stock on the day of the exercise.

For the tax years Year 5, Year 6, and Year 7, Corporation 1 is claiming deductions under § 174 for statutory stock options exercised by its employees who performed or were otherwise involved in R&D. The amounts of these claims are as follows:

Year 5	Amount 5
Year 6	Amount 6
Year 7	Amount 7

These claimed deductions are also based on the Spread.

Corporation 1 has informed the Exam Team that it is investigating whether some deductions for disqualifying deductions under § 421(b) should have been claimed as a deduction under § 174 in a year before the disqualifying disposition. For purposes of this memorandum, we presume that all of the employees were involved in R&D that would qualify as research and development expenditures under § 174.

LAW AND ANALYSIS

This memorandum consists of two parts. It first examines § 174 and concludes that in light of § 174's legislative history the claimed deductions are not research or experimental expenditures under § 174. The memo then examines § 421 and its legislative history and concludes that § 421 generally does not permit a deduction for compensation attributable to a statutory stock option.

A. Not Expenditures Under § 174

1. General Overview

Section 174(a)(1) states, "A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction." The expenditures covered by § 174 may apply either to a general research program or to a specific project. Treas. Reg. § 1.174-1 provides two methods for treating a taxpayer's research or experimental expenditures that are incurred in connection with the taxpayer's trade or business. If a taxpayer adopts the method provided in § 174(a), the taxpayer may deduct as expenses research or experimental expenditures that are incurred in connection with the

taxpayer's trade or business. Treas. Reg. § 1.174-3(a). Alternatively, a taxpayer may elect to defer and amortize the expenses. Treas. Reg. § 1.174-4. Research or experimental expenditures which are neither treated as expenses nor deferred and amortized under section 174 must be charged to a capital account. Treas. Reg. § 1.174-2(a)(1).

As explained below, Corporation 1's claimed deductions should not qualify as expenditures given the legislative history of § 174.

2. Not an Expenditure

The Spread does not qualify as an expenditure under § 174 and, thus, should not be deducted. Treas. Reg. § 1.174-2(a)(1) defines the term "research or experimental expenditures" as meaning:

> [E]xpenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. . . . Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

While this definition is broad, it should be read in the context of Congress's purpose for enacting § 174.

Before Congress enacted § 174, there was significant confusion surrounding the tax accounting of research or experimental expenditures. House Ways and Means Committee Report No. 1337 described the situation before the enactment of § 174:

> No specific treatment is authorized by present law for research and experimental expenditures. To the extent that they are ordinary and necessary they are deductible; to the extent that they are capital in nature they are to be capitalized and amortized over useful life. . . . However, where projects are not abandoned and where a useful life cannot be definitely determined, taxpayers have had no means of amortizing research expenditures.

H.R. Rep. No. 1337 at 28 (1954). Section 174 allows taxpayers to deduct research and experimental expenditures which would otherwise be capitalized, but it should not be interpreted as covering statutory stock options. The House Report indicates that

Congress intended § 174 to make capital expenses deductible and to make deductible expenses associated with projects with an indeterminate useful lives. There is no suggestion that § 174 would undo the symmetry (discussed later in this memorandum) established by § 421 of no income to the taxpayer and no deduction to the employer.

The legislative history of § 174 indicates that Congress had two purposes for enacting § 174: 1) To encourage research and experimental activities and 2) To eliminate the uncertainty as to the tax treatment of research and experimental expenditures. House Ways and Means Committee Report No. 1337 noted, "To eliminate uncertainty and to encourage taxpayers to carry on research and experimentation the committee bill provides that these expenditures . . . may, at the option of the taxpayer, be treated as deductible expenses." H.R. Rep. No. 1337 at 28 (1954). See also Rev. Rul. 85-186, 1985-2 C.B. 84. There is no indication, however, that the enactment of § 174 was going to alter the deductibility of statutory stock options.

In Rev. Rul. 85-186, the Service concluded that the sale of the resulting technology does not trigger the recapture of expenses previously deducted under § 174. As part of its analysis, Rev. Rul. 85-186 discussed the legislative history of § 174. Rev. Rul. 85-186 noted that § 174(a) deviates from the general rules governing expenditures by allowing a current deduction for research or experimental expenditures even though the expenditures might create an asset with a useful life beyond the tax year. The legislative history does not indicate that Congress intended to encourage research and experimental expenditures by altering the treatment of statutory stock options. In essence, § 174 is a special accounting method, not a vehicle for altering the rules governing the deductibility of statutory stock options.

B. Section 421 Does not Permit a Deduction under § 174

Section 421 specifically disallows a deduction under § 162 for compensation attributable to a stock option granted under §§ 422 or 423 (except in cases of disqualifying dispositions). Given its legislative history, § 421 also does not permit statutory stock options to be deducted under § 174.

In this section of the memo, we first provide an overview of the tax treatment of stock options. We then explain § 421's legislative history and the sole circumstances when § 421 permits a deduction for a statutory stock option. Finally, we discuss and reject taxpayer's argument that § 421 does not bar an employer from claiming a § 174 deduction for the Spread of a statutory stock option.

1. Overview of Tax Treatment on Stock Options

Generally, employers may deduct compensation attributable to stock options pursuant to § 162(a)(1), which permits a deduction for "reasonable allowance for salaries or other compensation." Employers compensate employees with two types of stock options: (1) nonstatutory stock options and (2) statutory stock options.

Section 83 sets out the tax treatment for nonstatutory stock options. If the nonstatutory stock option has a readily ascertainable fair market value when it is granted, the recipient receiving the option realizes income at that time. Treas. Reg. § 1.83-7(a). The recognized income is the fair market value less the amount paid for the option. If the nonstatutory stock option does not have a readily ascertainable fair market value when it is granted, Treas. Reg. § 1.83-7(a) provides that the recipient receiving the option recognizes income when the recipient exercises the nonstatutory stock option. The recognized income equals the fair market value of the stock on the date of exercise less the exercise price. We refer to this amount as the compensatory element of the stock option. Section 83(h) provides that an employer may deduct the compensatory element of the stock option under § 162. The congressional policy underlying § 83(h) is that an employer may deduct the compensatory element only if the compensatory element is included in the gross income of the recipient. See Tilford v. Commissioner, 705 F.2d 828, 830-31 (6th Cir. 1983); Venture Funding, Ltd. v. Commissioner, 110 T.C. 236, 242 (1998), aff'd without opinion, 198 F. 3d 248 (6th Cir. 1999).

Section 421 sets out the tax treatment for statutory stock options. Statutory stock options include incentive stock options ("ISOs") and options granted under employee stock purchase plans ("ESPPs"). Section 422 sets out the requirements for ISOs. Section 423 sets out the requirements for ESPPs and for options granted under such plans. Section 421(a)(1) provides that "no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share." Section 421(a)(2) provides that,

> no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 424(a) applies, with respect to the share so transferred.

Accordingly, § 421(a) provides different tax treatment than § 83(a). Whereas § 83(a) requires an employee to recognize income on the date of exercise of the nonstatutory stock option if the option did not have an ascertainable fair market value on the date of grant, § 421(a)(1) does not require such recognition. Consistent with the policy that an employer may deduct the compensatory element of a stock option only if the compensatory element is included in the gross income of the employee, § 421(a)(2) does not permit a deduction for the compensatory element attributable to statutory stock options because the compensatory element is excluded from the employee's gross income. Treas. Reg. § 1.421-2(a)(1)(ii) reinforces this tax treatment by providing that, "No deduction under sections 83(h) or 162 or the regulations thereunder (relating to trade or business expenses) is allowable to any time with respect to the share so transferred."[2]

[2] Discussing an ISO, Example 7 of Treas. Reg. § 1.424-1(c)(4) notes in passing that a corporation is not

2. Legislative History of Section 421

The legislative history for ESPPs and ISOs demonstrate Congress's intent that § 421(a)(2) does not permit an employer to deduct the compensatory element of a statutory stock option. The Revenue Act of 1964 provided the tax treatment for ESPPs. House Report No. 749 (1963) explained the intended tax treatment for stock options granted pursuant to ESPPs:

> As indicated previously, except for the addition of the nondiscrimination requirement (and the requiring of stockholder approval) the tax treatment of employee stock purchase plans continues to be substantially similar to the tax treatment of restricted stock options under present law. Thus, as under present law, no income is to be reported by the employee either at the time the option is granted or at the time it is exercised. Similarly, no deduction is available to the employer corporation with respect to the employee stock purchase plan.

1964 U.S.C.C.A.N. (vol. 1) at 1377 (Emphasis added). The Report's provision that "no deduction is available to the employer corporation with respect to the employee stock purchase plan" is unqualified. The Report does not provide that a deduction may be available to the employer corporation under another section of the Code. Congress enacted § 174 in 1954. If Congress intended for a deduction to be available under § 174 for compensation attributable to stock options granted under an ESPP, it would have qualified its 1964 statement that "no deduction is available to the employer corporation with respect to the employee stock purchase plan."

House Report No. 749 also explained the intended tax treatment of qualified stock options, which are the predecessors to ISOs:

> Generally, in the case of qualified stock options, no income tax is imposed either at the time the option is granted or at the time the option is exercised and the stock is transferred to the employee. Similarly, no business expense deduction is allowed to the employer corporation (or a parent or subsidiary of that corporation) at any time with respect to this option.

1964 U.S.C.C.A.N. (vol. 1) at 1374 (Emphasis added). The provision in House Report No. 749 (emphasis added) that "no business expense deduction is allowed to the employer corporation" may be interpreted as being less restrictive than the comparable provision for ESPPs ("no deduction is available to the employer corporation") because the phrase "business expense" might qualify the provision to disallow a deduction only under § 162 and make the deduction available under other Code sections. This interpretation is incorrect. Section 421 provides the tax treatment for both types of stock options; thus, the provision which does not permit a deduction for compensation

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entitled to any deduction at any time for the ISO.

attributable to qualified stock options should be treated the same as the provision for stock options granted under ESPPs. The legislative history governing ISOs further bolsters this interpretation.

The Economic Recovery Tax Act of 1981 established ISOs. P.L. 97-34. Senate Report 97-144 states the intended tax treatment for ISOs:

> The bill provides for "incentive stock options," which will be taxed in a manner similar to the tax treatment previously applied to restricted and qualified stock options. That is, there will be no tax consequences when an incentive stock option is granted or when the option is exercised, and the employee will be taxed at capital gains rates when the stock received on exercise of the option is sold. Similarly, no business expense deduction will be allowed to the employer with respect to an incentive stock option.

1981 U.S.C.C.A.N. (vol. 2) at 202 (Emphasis added). The emphasized language is unequivocal that there are no tax consequences when an ISO is granted or exercised. The reference in the last sentence to "no business expense deduction" reinforces the preceding sentence that there are no tax consequences when an ISO is granted or exercised; it does not limit the preceding sentence.

3. Section 421 Allows the Deduction of Compensation Attributable to Stock Options under Only One Circumstance

An employer may deduct the compensatory element attributable to a statutory stock option under one circumstance only — if the employee disposes of the stock in a disqualifying disposition. § 421(b). A disqualifying disposition occurs when the employee does not meet the holding requirements that are required by §§ 422(a)(1) (for stock acquired by exercising ISO's) or 423(a)(1) (for stock acquired by exercising options granted under an ESPP). To receive the beneficial tax treatment of § 421(a) (exclusion of the compensatory element from gross income on date of exercise), Congress required that employees meet the holding requirements of §§ 422(a)(1) or 423(a)(1).

If the employee disposes of the stock in a disqualifying disposition, then the employee is required to include the compensatory element of the stock option (generally measured as the Spread on the date of exercise) in gross income in the year of disposition. § 421(b). The tax consequences for the employee in a disqualifying disposition are essentially the same as the tax consequences for exercising a nonstatutory stock option under § 83(a). Indeed, Treas. Reg. § 1.421-2(b)(1) provides that the rules of §§ 83(a) and (h) apply to determine the tax consequences to the employee and the employer corporation when the employer disposes of the stock in a disqualifying disposition. Because the employee is required to include the compensatory element of a stock option in gross income as a result of a disqualifying disposition, Congress provided that the employer corporation may deduct the compensatory element. By permitting the

deduction, Congress reinforced the policy that an employer may deduct the compensatory element only if the compensatory element is includible in the gross income of the employee. Treas. Reg. § 1.421-2(b)(1) provides that the employer may take this deduction under § 162.

4. Taxpayer's Argument

Corporation 1 argues that because the text of § 421(a)(1) specifically disallows a deduction under §162 for compensation attributable to a statutory stock option then a deduction for such compensation is allowable under another section of the Code. Section 421(a) provides for the exclusion of the compensatory element from an employee's gross income. In essence, by claiming that it is entitled to a deduction under § 174, Corporation 1 effectively seeks to receive the tax benefits of § 83(h), which provides for a deduction for the employer, for ISOs and ESPPs that are eligible for tax treatment provided in § 421(a). Effectively, Corporation 1 argues that it is entitled to a deduction triggered by a disqualifying disposition without the disqualifying disposition taking place and without an employee recognizing income.

Corporation 1's argument and "plain reading" of § 421 are disingenuous. Corporation 1's position violates congressional policy that an employer may deduct the compensatory element of a stock option only if the compensatory element is included in the gross income of the employee. In Albertson's Inc. v. Commissioner, 42 F.3d 537, 545 (9th Cir. 1994), the Ninth Circuit reasoned that it "may not adopt a plain language interpretation of a statutory provision that directly undercuts the clear purpose of the statute." In Albertson's, the taxpayer argued that certain amounts paid into deferred compensation agreements constituted interest and could be deducted under § 404. The Ninth Circuit, however, concluded that not withstanding the statutory language, the taxpayer's interpretation would not be consistent with Congress's intent.

The Ninth Circuit's reasoning in Albertson's should apply to this situation. Provided the required holding periods are satisfied, Congress intended to prohibit an employer corporation from deducting the compensatory element of a statutory stock option. The legislative history of § 421 reinforces the policy that an employer may deduct the compensatory element of a stock option only if the compensatory element is included in the gross income of the employee. Accordingly, Section 421(a)(2) does not permit a deduction for the compensatory element attributable to statutory stock options because the compensatory element is excluded from the employee's gross income.

C. Conclusion

As discussed earlier, Corporation 1 may not deduct the Spread of a statutory stock option under § 174. In addition, § 421 also does not permit Corporation 1 to deduct the Spread of a statutory stock option.

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Please call (415) 227-5143 if you have any further questions.

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