ISOs by Another Name?

By Robert W. Wood • Wood LLP • San Francisco

There are incentive stock options (ISOs) and nonqualified stock options (NSOs) and they are taxed differently. There is no regular tax when an ISO is granted or exercised. The employee has capital gain when selling stock at a gain. In *D.S. Stout* [110 TCM 92, Dec. 60,352(M), TC Memo 2015-133], the IRS considered a stock-equivalent plan that issued stock incentive units (SIUs) to employees. Their value was measured by the value of the company's stock, so Mr. Stout claimed they functioned as an ISO and qualified as one.

The Pole Zero Corp. stock-equivalent plan credited SIUs to accounts maintained for the benefit of plan participants. Their value was measured by the fair market value of a share of Pole Zero common stock. Plan participants received credits to their plan accounts equal to cash dividends relating to each share of common stock.

These dividend equivalents accrued interest, but all credits represented only an unsecured promise to pay. On a merger or acquisition of Pole Zero, participants had the right to receive cash equal to the value of their plan accounts. When the company was acquired, Mr. Stout was paid the value of his plan account.

He claimed the payment qualified for capital gain treatment. The Tax Court ruled it was not an ISO and was ordinary income.

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