26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, Section 2512; Section 25.2512–1.)

Rev. Proc. 98–34

SECTION 1. PURPOSE

This revenue procedure sets forth a methodology to value for gift, estate, and generation-skipping transfer tax ("transfer tax") purposes certain compensatory stock options described in Section 3 of this revenue procedure. Taxpayers relying on this revenue procedure may use an option pricing model that takes into account on the valuation date specific factors that are similar to those established by the Financial Accounting Standards Board in Accounting for Stock-Based Compensation, Statement of Financial Accounting Standards No. 123, (Fin. Accounting Standards Bd. 1995), (FAS 123). The Internal Revenue Service will treat the value of a compensatory stock option as properly determined for transfer tax purposes, provided that the requirements of this revenue procedure are met.

SECTION 2. BACKGROUND

Section 2512(a) of the Internal Revenue Code provides that, if a gift is made in property, the value of the property at the date of the gift is the amount of the gift.

Section 25.2512–1 of the Gift Tax Regulations provides that for gift tax purposes the value of property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

Section 2031(a) provides that the value of the gross estate is determined by including the value at the time of the decedent's death of all property, real or personal, tangible or intangible, wherever situated.

Section 20.2031–1(b) of the Estate Tax Regulations provides that the value of every item of property includible in a decedent's gross estate is its fair market value at the time of the decedent's death.

Section 2032(a) provides that the executor may elect to use an alternate valuation date. Under this election, the value of all property included in the gross estate generally is determined as of 6 months after the decedent's death. However, property distributed, sold, exchanged, or otherwise disposed of within 6 months after death must be valued as of the date of sale, exchange, or other disposition.

Section 2624(a) provides that, except as otherwise provided in Chapter 13, property is valued at the time of the generation- skipping transfer.

FAS 123 establishes financial accounting and reporting standards for stock-based employee compensation plans. Under FAS 123, the fair value of a stock option granted by a public entity is estimated using an option pricing model (for example, the Black-Scholes model or a binomial model) that takes into account as of the option grant date: (1) the exercise price of the option; (2) the expected life of the option; (3) the current price of the underlying stock; (4) the expected volatility of the underlying stock; (5) the expected dividends on the underlying stock; and (6) the risk-free interest rate for the expected term of the option.

FAS 123 generally requires a public entity to disclose in its financial statements for each year beginning after December 15, 1994, a description of the method and significant assumptions used during the year to estimate the fair value of stock options granted during the year, including the following weighted-average information: (1) expected life of the options; (2) expected volatility; (3) expected dividends; and (4) risk-free interest rate. (The foregoing is not a complete list of the disclosures required by FAS 123. For example, FAS 123 also requires financial statement disclosure of the weighted-average exercise prices of options granted during the year.)

SECTION 3. SCOPE

This revenue procedure applies only to the valuation for transfer tax purposes of nonpublicly traded compensatory stock options (that is, stock options that are granted in connection with the performance of services, including stock options that are subject to the provisions of § 421), on stock that, on the valuation date, is publicly traded on an established securities market. The options to which this revenue procedure applies are referred to herein as "Compensatory Stock Options."

SECTION 4. APPLICATION

.01 Taxpayers may determine the value of Compensatory Stock Options for transfer tax purposes by using a generally recognized option pricing model (for example, the Black-Scholes model or an accepted version of the binomial model) that takes into account as of the valuation date the following factors: (1) the exercise price of the option; (2) the expected life of the option; (3) the current trading price of the underlying stock; (4) the expected volatility of the underlying stock; (5) the expected dividends on the underlying stock; and (6) the risk-free interest rate over the remaining option term.

.02 In order to rely on this revenue procedure: (1) the taxpayer must use the factors determined in section 4.03 through 4.07 of this revenue procedure; (2) each of the factors used in applying the option pricing model must be reasonable (for this purpose, the use of the factors in section 4.03 through 4.07 of this revenue procedure will be deemed reasonable); (3) the option pricing model must be properly applied; (4) the company that granted the option must be subject to FAS 123 in preparing its financial statements for the fiscal year of the company that includes the valuation date; (5) the underlying stock must be common stock and must be the same stock for which the expected volatility and expected dividends were estimated by the company for purposes of FAS 123; and (6) no discount can be applied to the valuation produced by the option pricing model (for example, no discount can be taken due to lack of transferability or due to the termination of the option within a specified number of days following termination of employment).

.03 Except as provided in section 4.04 of this revenue procedure, in determining the factor for the expected life of the option, taxpayers must use either (1) the maximum remaining term of the option on the valuation date (Maximum Remaining Term), or (2) the expected life of the option on the valuation date computed in accordance with this section (Computed Expected Life). The Maximum Remaining Term is the number of years rounded down to the nearest 1/10th of a year from the valuation date until the option's expiration date (assuming no condition or event occurs that would shorten the life of the option).

The Computed Expected Life is determined in the following manner:

Step one: Obtain the weighted-average expected life of options granted by the publicly traded company that, for purposes of complying with FAS 123, is disclosed in its financial statements for the fiscal year that includes the valuation date. (If, instead of disclosing a weighted-average expected life for options granted during the fiscal year, the company disclosed a method for computing the expected life of the options granted during the fiscal year, the taxpayer must compute the weighted-average expected life for the taxpayer's option using the method disclosed by the company.)

Step two: Divide the weighted-average expected life determined in step one by the number of years, rounded up to the nearest 1/10th of a year, from the date the option was granted (without regard to the application of § 424(h)(1)) until the option's expiration date (assuming no condition or event occurs that would shorten the life of the option).

Step three: Multiply the quotient obtained in step two by the Maximum Remaining Term. The resulting number rounded down to the nearest 1/10th is the Computed Expected Life expressed in years.

This calculation can be demonstrated by the following example. Assume that on September 1, 1998, *A* is granted a stock option from Company that will terminate on the earlier of the date 10 years from the date of grant or the date 90 days after the termination of *A*'s employment with Company. The option becomes fully exercisable 3 years from the date of grant. For the fiscal year that includes September 1, 2001, Company discloses in a footnote to its financial statements, in accordance with FAS 123, that the weighted-average expected life of stock options granted by the Company during the fiscal year is 6 years. On September 1, 2001, when *A*'s option becomes fully exercisable, *A* makes a gift of a portion of the option. On September 1, 2001, *A*'s option qualifies as a Compensatory Stock Option. For purposes of step one, the weighted-average expected life is 6 years, as disclosed by Company for purposes of complying with FAS 123 for the fiscal year that includes the valuation date. For purposes of step two, the weighted-average expected life of 6 years is divided by 10 years, the maximum term of *A*'s option on the date the option was granted by Company. The resulting quotient is 0.6 (6 years divided by 10 years equals 0.6). For purposes of step three, the quotient in step two is multiplied by the Maximum Remaining Term to determine the Computed Expected Life. The result is 4.2 years (0.6 times 7 years equals 4.2 years).

.04 Taxpayers must use the Maximum Remaining Term (and may not use the Computed Expected Life) as the expected life of the option on the valuation date if one (or more) of the following conditions is present:

(1) the transferor of the option (or the decedent, in the case of a transfer at death) is not the person to whom the option being valued was granted by the company;

(2) except in the case of a transfer at death, the transferor is not an employee or director of the company on the valuation date;

(3) except in the case of the death or disability (within the meaning of § 22(e)(3)) of the transferor, the option being valued does not terminate within 6 months of termination of employment (or service as a director) of the transferor with the company;

(4) the terms of the option being valued permit the option to be transferred to, or for the benefit of, one or more persons other than either persons who are the natural objects of the transferor's bounty or a charitable organization;

(5) except in the case of the death of the transferor, the option being valued has an exercise price that is not fixed on the valuation date. The option does not have a fixed exercise price if, for example, the exercise price is determined by a formula the results of which might change after the valuation date. In addition, an option will be deemed not to have a fixed exercise price if the company issuing the option has repriced options (that is, directly or indirectly lowered the exercise price of outstanding compensatory stock options) within the 3-year period ending on the valuation date;

(6) except in the case of the death of the transferor, the option being valued has terms and conditions such that if all the options granted in the fiscal year of the company that includes the valuation date had the same terms and conditions, the weighted-average expected life for the year would have been more than 120% of the weighted-average expected life actually reported for the year; or

(7) the company is not required by FAS 123 to disclose an expected life of the options granted in the fiscal year of the company that includes the valuation date.

.05 In determining the factor for the expected volatility of the underlying stock, taxpayers must use the expected volatility of the underlying stock that, for purposes of complying with FAS 123, is disclosed in the financial statements of the publicly traded company for the fiscal year of the company that includes the valuation date.

.06 In determining the factor for the expected dividends on the underlying stock, taxpayers must use the expected dividends on the underlying stock that, for purposes of complying with FAS 123, is disclosed in the financial statements of the publicly traded company for the fiscal year of the company that includes the valuation date.

.07 In determining the factor for the risk-free interest rate, taxpayers must use the yield to maturity on the valuation date of zero-coupon U.S. Treasury Bonds with a remaining term (as of the valuation date) nearest to the expected life of the option on the valuation date as determined in section 4.03 of this revenue procedure.

.08 Taxpayers utilizing this revenue procedure to value a Compensatory Stock Option for transfer tax purposes should indicate on the applicable gift, estate, or generation-skipping transfer tax return: "FILED PURSUANT TO REV. PROC. 98–34."

DRAFTING INFORMATION

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