

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also, Part 1, 280G.)

Rev. Proc. 2002-45

SECTION 1. PURPOSE

Revenue Procedure 2002-13, 2002-8 I.R.B. 549, provided guidance on valuing stock options for nonpublicly traded stock and publicly traded stock for purposes of §§ 280G and 4999 of the Internal Revenue Code. This revenue procedure modifies portions of Rev. Proc. 2002-13.

SECTION 2. BACKGROUND

Rev. Proc. 2002-13 provides a methodology for valuing stock options for purposes of §§ 280G and 4999. Stock options must be valued for purposes of §§ 280G and 4999 when a payment in the nature of compensation involves a stock option, such as when the grant of the option is a payment in the nature of compensation contingent on a change in ownership or control or, with respect to an option previously granted to the taxpayer, when the option becomes substantially vested within the meaning of § 1.83-3(b) and (j) as a result of the change in ownership or control. Rev. Proc. 2002-13 does not apply for purposes of valuing a payment in cash, even though the cash is determined by reference to the cancellation of a stock option.

Generally, Rev. Proc. 2002-13 provides that a taxpayer may value a stock option using any valuation method that is consistent with generally accepted accounting principles (such as Statement of Financial Accounting Standards No. 123 (Fin. Accounting Standards Bd. 1995 (FAS 123)) and that takes into account the factors provided in § 1.280G-1 of the Proposed Income Tax Regulations, Q&A-13, published in the **Federal Register** on February 20, 2002 (REG-209114-90,

2002–9 I.R.B. 576 [67 F.R. 7630]) (the 2002 proposed regulations) and on May 5, 1989 (PS–217–84, 1989–1 C.B. 1038 [54 F.R. 19390]) (the 1989 proposed regulations). In addition, section 4 of Rev. Proc. 2002–13 provides a valuation method based on the Black-Scholes model.

Rev. Proc. 2002–13 provides that, if the stock option is one that could otherwise be valued under Rev. Proc. 98–34, 1998–1 C.B. 983, because the stock option is a “Compensatory Stock Option,” as defined in section 3 of Rev. Proc. 98–34 (*i.e.*, a nonpublicly traded option for stock that is publicly traded on an established securities market), then, for purposes of §§ 280G and 4999 and Rev. Proc. 2002–13, the valuation is not considered consistent with generally accepted accounting principles unless the valuation is made in accordance with Rev. Proc. 98–34 or the valuation safe harbor method described in section 4 of Rev. Proc. 2002–13.

Rev. Proc. 98–34 provides a methodology for valuation of certain compensatory stock options for purposes of gift, estate, and generation-skipping transfer taxes. The methodology described in Rev. Proc. 98–34 is an option pricing model that takes into account factors similar to those established in FAS 123. This methodology applies only to the valuation of a nonpublicly traded compensatory stock option for stock that, on the valuation date, is publicly traded on an established securities market.

Since the issuance of Rev. Proc. 2002–13, commentators have suggested that the two valuation methods available for Compensatory Stock Options do not adequately take into account all of the facts and circumstances relevant to the valuation of Compensatory Stock Options in the context of a change in ownership or control. Commentators have also requested an extension of the effective date provided in Rev. Proc. 2002–13, or a modification of Rev. Proc. 2002–13 to establish a safe harbor for Compensatory Stock Options, to provide opportunity for consideration of comments.

SECTION 3. MODIFICATIONS TO REV. PROC. 2002–13

01. Under Rev. Proc. 2002–13, a stock option for stock that is not publicly traded

(*i.e.*, an option that is not a Compensatory Stock Option as defined in Rev. Proc. 98–34) is considered properly valued for purposes of §§ 280G and 4999 if such value is determined using any valuation method that is consistent with generally accepted accounting principles (such as FAS 123) and takes into account the factors provided in § 1.280G–1, Q/A-13 of both the 1989 and 2002 proposed regulations. For purposes of the preceding sentence, the safe harbor valuation method provided in section 4 of Rev. Proc. 2002–13 is considered consistent with generally accepted accounting principles and takes into account the factors provided in § 1.280G–1, Q/A-13 of both the 1989 and 2002 proposed regulations. Pending further guidance, a stock option for stock that is publicly traded (*i.e.*, an option that is a Compensatory Stock Option as defined in Rev. Proc. 98–34) will be considered properly valued if the valuation method satisfies the standard set forth in Rev. Proc. 2002–13 for stock options that are not Compensatory Stock Options. Accordingly, the value of a Compensatory Stock Option will be considered properly determined if such value is determined in accordance with Rev. Proc. 98–34, with the safe harbor valuation method in section 4 of Rev. Proc. 2002–13, or with a valuation method that is consistent with generally accepted accounting principles (such as FAS 123) and that takes into account the factors provided in § 1.280G–1, Q/A-13 of both the 1989 and 2002 proposed regulations. For purposes of §§ 280G and 4999, however, regardless of whether the option is a Compensatory Stock Option, a stock option will not be considered properly valued if the option is valued solely by reference to the spread between the exercise price of the option and the value of the stock at the time of the change in ownership or control or without regard to the other factors provided in § 1.280G–1, Q/A-13 of both the 1989 and 2002 proposed regulations.

02. The Appendix to this revenue procedure provides a valuation table for use under section 4 of Rev. Proc. 2002–13 that supersedes the table provided in the appendix to Rev. Proc. 2002–13. The expanded table includes an additional column for use when the remaining term of the option is 3 months. For purposes of

section 4.04 of Rev. Proc. 2002–13, if the remaining term of the option is less than 12 months, the taxpayer may round down to the 3-month interval.

03. For purposes of determining the term factor under section 4.04 of Rev. Proc. 2002–13, the number of full months may be rounded down to the next lowest 12-month interval.

04. Section 4.02 of Rev. Proc. 2002–13 provides that, for purposes of valuing a stock option using the safe harbor valuation table in section 4 of Rev. Proc. 2002–13, the volatility factor used for stock that is publicly traded on an established securities market (or otherwise) is based on the volatility of the underlying stock used for purposes of FAS 123 and disclosed in the most recent financial statement of the corporation. In order to use the safe harbor in section 4 of Rev. Proc. 2002–13, the volatility factor in section 4.02 must be based on the volatility for the most recent year used for purposes of complying with FAS 123 and disclosed in the most recent financial statements of the corporation.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–13, 2002–8 I.R.B. 549, is modified.

SECTION 5. REQUEST FOR COMMENTS

Comments are requested regarding the methods described in this revenue procedure and Rev. Proc. 2002–13. In particular, comments are requested on how to determine the appropriate term assumptions for purposes of valuing stock options in connection with a change in ownership or control and on other approaches to addressing the particular facts and circumstances associated with a change in ownership or control (for example, whether it is appropriate to permit recalculation of the value of an option under certain circumstances, such as termination of employment within a short period after a change in ownership or control). All comments will be available for public inspection and copying. Comments must be submitted by August 12, 2002. Comments should be sent to CC: ITA:RU (Rev. Proc. 2002–45), room 5226, Internal Revenue Service, POB

7604, Ben Franklin Station, Washington, DC 20044. Comments may also be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (Rev. Proc. 2002-45), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. In the alternative, e-mail your comments to: *Notice.Comments@irscounsel.treas.gov*.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective June 13, 2002. Taxpayers may apply the rules in this revenue procedure for the valuation of a stock option on or after April 26, 2002.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Erinn Madden of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue procedure, contact Ms. Madden at (202) 622-6030 (not a toll-free call).

Appendix

	Term (months)	3	12	24	36	48	60	72	84	96	108	120
Volatility	Spread Factor*											
Low	200%	66.8%	67.3%	67.9%	68.4%	69.0%	69.5%	69.9%	70.3%	70.7%	71.0%	71.2%
	180%	64.5%	65.0%	65.7%	66.4%	67.1%	67.7%	68.3%	68.8%	69.3%	69.6%	69.9%
	160%	61.8%	62.4%	63.3%	64.1%	65.0%	65.8%	66.5%	67.1%	67.7%	68.1%	68.5%
	140%	58.6%	59.4%	60.4%	61.5%	62.5%	63.5%	64.4%	65.1%	65.8%	66.4%	66.9%
	120%	54.9%	55.8%	57.1%	58.4%	59.7%	60.9%	62.0%	62.9%	63.7%	64.5%	65.1%
	100%	50.4%	51.5%	53.2%	54.8%	56.4%	57.9%	59.1%	60.3%	61.3%	62.2%	63.0%
	80%	44.9%	46.3%	48.5%	50.6%	52.6%	54.3%	55.9%	57.3%	58.5%	59.6%	60.5%
	60%	38.0%	40.0%	42.9%	45.6%	48.0%	50.1%	52.0%	53.7%	55.2%	56.5%	57.6%
	40%	29.3%	32.3%	36.3%	39.7%	42.6%	45.2%	47.4%	49.4%	51.2%	52.7%	54.1%
	20%	18.1%	23.3%	28.5%	32.7%	36.2%	39.3%	41.9%	44.3%	46.4%	48.2%	49.9%
	0%	6.4%	13.6%	19.9%	24.7%	28.8%	32.3%	35.4%	38.1%	40.5%	42.7%	44.7%
	-20%	0.6%	5.4%	11.2%	16.1%	20.4%	24.2%	27.6%	30.6%	33.4%	35.9%	38.1%
	-40%	0%	0.9%	4.1%	7.9%	11.6%	15.2%	18.5%	21.7%	24.6%	27.3%	29.9%
-60%	0%	0.0%	0.6%	2.0%	4.0%	6.4%	9.0%	11.6%	14.3%	16.8%	19.3%	
Medium	200%	66.8%	67.4%	68.6%	69.9%	71.1%	72.2%	73.1%	73.9%	74.5%	75.0%	75.4%
	180%	64.5%	65.2%	66.7%	68.2%	69.6%	70.9%	71.9%	72.8%	73.5%	74.1%	74.6%
	160%	61.8%	62.7%	64.5%	66.3%	68.0%	69.4%	70.6%	71.6%	72.5%	73.2%	73.7%
	140%	58.6%	59.8%	62.0%	64.2%	66.1%	67.7%	69.1%	70.3%	71.2%	72.0%	72.7%
	120%	54.9%	56.4%	59.2%	61.7%	63.9%	65.8%	67.4%	68.8%	69.9%	70.8%	71.6%
	100%	50.4%	52.5%	55.9%	58.9%	61.5%	63.7%	65.5%	67.0%	68.3%	69.4%	70.3%
	80%	44.9%	47.9%	52.2%	55.7%	58.7%	61.2%	63.2%	65.0%	66.5%	67.7%	68.8%
	60%	38.2%	42.6%	47.8%	52.0%	55.4%	58.3%	60.6%	62.7%	64.3%	65.8%	67.0%
	40%	30.0%	36.3%	42.7%	47.6%	51.6%	54.8%	57.6%	59.9%	61.8%	63.5%	64.9%
	20%	20.3%	29.1%	36.8%	42.5%	47.0%	50.8%	53.9%	56.5%	58.8%	60.7%	62.3%
	0%	10.4%	21.2%	30.0%	36.4%	41.6%	45.8%	49.4%	52.4%	55.0%	57.2%	59.1%
	-20%	3.0%	13.0%	22.2%	29.2%	34.9%	39.7%	43.7%	47.2%	50.2%	52.8%	55.0%
	-40%	0.3%	5.7%	13.8%	20.8%	26.8%	32.0%	36.4%	40.4%	43.8%	46.8%	49.5%
-60%	0%	1.2%	5.9%	11.4%	16.9%	22.1%	26.7%	31.0%	34.8%	38.3%	41.4%	

Appendix—Continued

	Term (months)	3	12	24	36	48	60	72	84	96	108	120
Volatility	Spread Factor*											
High	200%	66.8%	68.1%	70.7%	73.1%	75.0%	76.6%	77.8%	78.8%	79.5%	80.0%	80.4%
	180%	64.5%	66.1%	69.1%	71.7%	73.9%	75.6%	77.0%	78.1%	78.9%	79.5%	79.9%
	160%	61.8%	63.8%	67.3%	70.3%	72.7%	74.6%	76.1%	77.3%	78.2%	78.9%	79.4%
	140%	58.6%	61.3%	65.3%	68.6%	71.3%	73.4%	75.1%	76.4%	77.4%	78.2%	78.8%
	120%	54.9%	58.3%	63.0%	66.8%	69.7%	72.1%	73.9%	75.4%	76.6%	77.4%	78.1%
	100%	50.6%	55.0%	60.4%	64.6%	67.9%	70.6%	72.6%	74.3%	75.6%	76.6%	77.3%
	80%	45.3%	51.1%	57.4%	62.2%	65.9%	68.8%	71.1%	73.0%	74.4%	75.6%	76.5%
	60%	39.1%	46.6%	54.0%	59.4%	63.5%	66.8%	69.4%	71.4%	73.1%	74.4%	75.4%
	40%	31.7%	41.4%	50.0%	56.1%	60.7%	64.4%	67.3%	69.6%	71.5%	73.0%	74.2%
	20%	23.2%	35.4%	45.3%	52.1%	57.4%	61.5%	64.8%	67.4%	69.6%	71.3%	72.7%
	0%	14.3%	28.5%	39.6%	47.4%	53.3%	57.9%	61.6%	64.7%	67.1%	69.1%	70.8%
	-20%	6.4%	20.8%	32.9%	41.5%	48.1%	53.4%	57.6%	61.1%	64.0%	66.4%	68.3%
	-40%	1.5%	12.7%	24.8%	34.0%	41.4%	47.3%	52.2%	56.3%	59.7%	62.5%	64.8%
	-60%	0.1%	5.2%	15.2%	24.3%	32.1%	38.8%	44.4%	49.1%	53.2%	56.6%	59.5%

*Spot (market) Price/Exercise Price – 1 or (S/X–1)