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Revenue Procedure 2002-13 and the Valuation of Compensatory Stock Options

The IRS has issued safe harbor methodology for valuing stock options in Revenue Procedure 2002-13. A previous safe harbor methodology, Revenue Procedure 1998-34, applied only to publicly traded stock. Both Revenue Procedures state that taxpayers may value stock options using methodology consistent with generally accepted accounting principles, such as SFAS 123. SFAS 123 provides guidance for valuing employee options based upon generally accepted accounting principles and suggests using an option pricing model with adjustments made to some of the inputs due to the nontransferability of the option.

> ***The IRS has issued safe harbor methodology for valuing stock options in Revenue Procedure 2002-13***

Revenue Procedure 2002-13 provides safe harbor for valuing compensatory stock options that is said to be based on the Black-Scholes Option Pricing Model (Black-Scholes). It suggests that taxpayers may value a compensatory stock option using any valuation method that is consistent with generally accepted accounting principles (such as SFAS 123) and that take into account the factors provided in Proposed Regulation 1.208G-1, Q&A 13.

What are the differences between the various methods?

1. **Volatility.** Per Revenue Procedure 2002-13, if the stock is not publicly traded and the corporation is not required to register under the SEC Act of 1934, the taxpayer must assume medium volatility (annual stdev of returns of between 30% and 70%), otherwise the taxpayer uses the volatility disclosed in the most recent financial statements for purposes of complying with SFAS 123. Revenue Procedure 98-34 requires using the volatility factor reported in the company's financial statements. SFAS 123 recommends using long term historical volatility for publicly traded companies and non-publicly traded companies can assume zero volatility.

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Divorce Engagements and Valuation Terms

With the evolution of mediation requirements, divorcing parties and their advisers are discovering the importance of early involvement by a qualified valuation professional. Defining the engagement and understanding the requirements of the work product is crucial. Unfortunately, there may be a lack of understanding as to what a "valuation" is. In fact, depending on the circumstances of a given situation, there are different products and services that may fit the need (see Table 1 on page 2). Report documentation, analytical procedures and assumptions, and fee structure can be greatly affected by the nature of the chosen product or service. For

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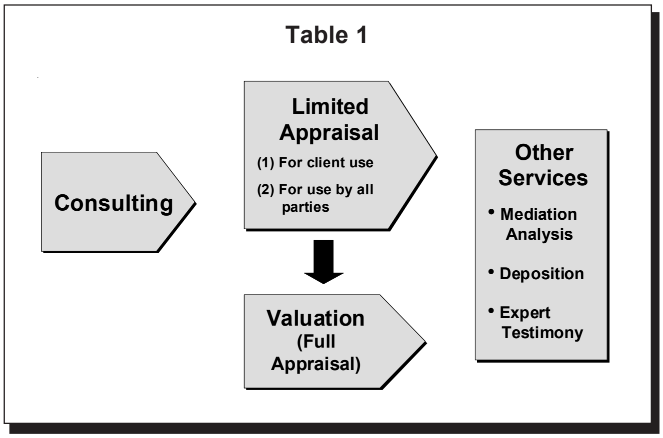

the purpose of this article, we will focus on "limited appraisals" and "valuations or full appraisals."

Limited Appraisal. A limited appraisal is "the act or process of determining the value of a business, business ownership interest, security, or intangible asset with limitations in analyses, procedures, or scope."* Limited appraisals can substantiate value but are not typically styled a "valuation." Because in many cases limited appraisals do not require an on-site inspection, extensive industry and market research, or detailed documentation, they can save time and expense. However, limited appraisals can be elevated to a valuation (or full appraisal) when formality and completeness is needed for the Court or in response to the scope of an opposing expert's work.

Valuation (Full Appraisal). A valuation is "the act or process of determining the value of a business, business ownership interest, security, or intangible asset."* A valuation requires, among other things, an on-site visit with company management, extensive industry and economic research, and collection and analysis of all information expected to be relevant to the valuation.

The valuation process involves defining the engagement, collecting and analyzing financial and business information, researching relevant valuation data, developing the valuation, and communicating the result via an agreed upon level of documentation and/or testimony. We encourage divorce attorneys to be rigorous in selecting valuation experts. Educated consumers of valuation services enhance the quality of service ultimately delivered to the client. If you have any questions about the services we provide, please do not hesitate to call us. ◆

* *International Glossary of Business Valuation Terms*, 2001. AICPA, American Society of Appraisers, Canadian Institute of Charted Business Valuators, National Association of Certified Valuation Analysts, and the Institute of Business Appraisers.

Case Law Update

Dunn v. Commissioner

(Docket No. 00-60614, 5th Cir.)

Background. In August 2002, the 5th Circuit Appellate Court reversed and remanded a 2000 Tax Court decision regarding the *Estate of Beatrice Dunn* (TC Memo 2000-12). Beatrice Dunn's estate owned almost 63% of the Dunn Equipment Company ("Dunn"), a family owned, privately held, heavy equipment rental facility. The Tax Court made an extensive valuation analysis. The Tax Court concluded that the decedent's 63% block of stock gave her operational control, but did not give her the power to compel liquidation or merger. This required a 66.67% block under Texas law. The Tax Court concluded that the decedent could not likely garner votes to obtain that super majority and also concluded that the process of liquidating would be long and expensive. Therefore, liquidation was not imminent. The Appellate Court did not find any error in the lower Court's findings thus far.

The Tax Court's valuation analysis included an earnings-based value ($1.3 million) and asset-based value ($7.9 million). The asset-based value included a 5% factor for built-in capital gains liability, not the actual rate of 34% Dunn would have incurred. The Court weighted the earnings-based approach 35% and 65% to the asset based approach. The Tax Court then assigned a 22.5% discount, consisting of 15% for lack of marketability and 7.5% for lack of super-majority control. The Tax Court's valuation conclusion was $2.74 million, versus $1.64 million by the Estate and $4.43 million by the Commissioner. The Appellate Court was only asked to review the appropriate discount to apply to the value of the assets of Dunn to account for built-in tax liability and the relative weights to apply to each valuation measure.

Appellate Court Decision. In previous cases, the Tax Court has deemed appropriate a discount to reflect the built-in capital gains tax liability. The Appellate Court found the Tax Court's conclusion that a buyer of operational control of Dunn would not seek a discount to reflect built-in tax liability, absent the buyer's intent to liquidate, to be fundamentally wrong. The Appellate Court indicated that "as a matter of law, the built-in tax liability of this particular business' assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of the Company." Therefore, the discount should be 34%. The 5th Circuit also indicated that the Tax Court's consideration of the likelihood of liquidation was flawed. The Appellate Court indicated that when applying the asset-based valuation method, it must be assumed that all assets will be sold, noting that the earnings approach considers value if the assets are retained.

The Appellate Court agreed with the Tax Court's determination that the likelihood of liquidation was minimal. The Appellate Court notes, that given the

Tax Court's analysis, the earnings approach should be weighted more. The Appellate Court indicated that this is reversible error.

On remand, the Tax Court is instructed to give the earnings-based value a weight of 85%, and the asset-based approach 15% weight. The Tax Court must apply a 34% discount to the asset based conclusion to reflect the built-in capital gains. After calculating the pro rata value of the Estate's 63% share, a 22.5% discount for lack of marketability and lack of super-majority control is appropriate. ◆

Corporate Reform Update

Sarbanes-Oxley Act

With much fanfare, Congress passed and the President recently signed new securities legislation (Sarbanes-Oxley Act of 2002) meant to curb weaknesses in laws, regulations, and oversight believed to have contributed to the recent spate of less than admirable disclosures of corporate accounting and governance shortcomings. Experts seem somewhat divided as to whether the legislation is momentous or merely mundane, although the legislation's full impact awaits the promulgation of rules by the SEC and the Accounting Oversight Board. Accountants and accounting firms bear the brunt of the legislation, as about half of the bill is devoted to the new Accounting Oversight Board and auditor independence issues.

The Accounting Oversight Board is given seemingly broad authority to adopt standards governing attestation procedures, audit quality control, and auditor ethics, responsibilities formerly performed by committees of the American Institute of Certified Public Accountants. However, the Accounting Oversight Board can incorporate standards previously adopted by other professional organizations into its rules.

The auditor independence regulations stiffen the rules adopted by the SEC in 2001, as indicated in the following chart that compares the new securities act to the SEC's rules. The most significant new limitations on non-audit services appear concentrated in the areas of systems design and implementation and internal audit services. Accounting firms apparently escaped a requirement to rotate clients every few years. Instead, the firm must replace the engagement partner after five years.

Given the recent events concerning noted public companies, many people are nervous. This corporate responsibility legislation is an attempt to calm the markets

Section 301 of the new legislation is devoted exclusively to audit committees, which provides that the audit committee has direct responsibility for the appointment, compensation, and oversight of the auditing firm.

Section 204 also applies directly to audit committees. It provides that the auditor must report to the audit committee regarding (i) the critical accounting policies used; (ii) alternative accounting treatments discussed with management, their financial effect, and the treatment preferred by the auditor; and, (iii) communications with management, such as management letters or schedules of unadjusted differences. The legislation also requires that the company must disclose whether one audit committee member is a "financial expert," possessing significant knowledge regarding accounting and internal control matters.

From the legislation, it is unclear what level of "due diligence" the audit committee must conduct to properly carry out its oversight responsibilities. The act gives the audit committee latitude to retain legal counsel or other advisors to assist in conducting its duties. For instance, if the auditor discusses several alternative accounting treatments with management, would the audit committee need to retain a second accounting firm to concur with the selected accounting treatment? While the legislation references auditors and their work product, what responsibility does the audit committee have with respect to other financial disclosures by the company? Given the legislation's core focus on investor protection, do these disclosures need to be evaluated for transparency?

Sections of the legislation concerning corporate officers focus more on exacting new or tougher penalties for malfeasance, rather than creating large-scale revisions, as for accounting firms. Chief executive officers and chief financial officers must certify financial statements in a form paralleling a standard audit opinion; that is, the company's financial statements "present fairly, in all material respects" its financial position and results of operations. In addition, Section 1001 of the Act recommends that the federal income tax return of a corporation be signed by the chief executive officer of such corporation, which may subject the chief executive officer to other potential tax penalties if a fraudulent tax return is filed.

Given the recent events concerning noted public companies, many people are nervous. This corporate responsibility legislation is an attempt to calm the markets. We note that the vast majority of firms and people that are addressed by this Act are reputable and concerned with what is best for their clients and their employees.

Give us a call if you have valuation or other transaction advisory needs. We serve our clients' best interests first with the highest standard of service and level of professionalism. ◆

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Revenue Proc. 2002-13 and the Valuation of Compensatory Stock Options

(Continued from Page 1)

2. **Time.** Under Revenue Procedure 2002-13, the time to be used is the time remaining until expiration. Revenue Procedure 98-34 has a complicated method of calculating the Computed Expected Life based on what is disclosed in the financial statements of the company. SFAS 123 recognized that since the options were non-transferable, the only way to enjoy the benefits from them was to exercise, suggesting that the time would be less than the expiration date.

An example is presented that compares the computed values of stock options of a *publicly traded* company using Revenue Procedure 2002-13 safe harbor methodology with the value of the same options using methodology suggested by SFAS 123. If the stock is not publicly traded and the company is not required to register under the Securities Exchange Act of 1934, the safe harbor regulations under Revenue Procedure 2002-13 computes a value of $12.19 for the option, while the Black-Scholes Model (modified according to SFAS 123) produces a value of $1.22.

As said previously, Revenue Procedure 2002-13, said to be based on Black-Scholes, suggests that taxpayers may value a compensatory stock option using any valuation method that is consistent with generally accepted accounting principles (such as SFAS 123) and that take into account the factors provided in Proposed Regulation 1.208G-1, Q&A 13. Since time and volatility have the most effect on option values when using Black-Scholes, it is possible to calculate widely different option values using the various methodologies. Your appraiser should be well versed in each methodology. ◆

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Assumptions	
Current Market Value of Stock (Marketable Minority Interest Basis)	$24.00
Strike Price of Option	$20.00
Time to Expiration (Years)	5.0
Time to Expected Exercise (Years)	2.5
Annual Dividend	$0.75
Shares Outstanding	1,000,000
Common Share Equivalents Representd by Options	5,000
Option Holder Receives Rule 144 Stock Upon Exercise	Yes
Publicly Traded Stock	**Yes**

Value per each Method (Publicly Traded)

	Volatility 20%	Volatility 31%	Volatility 50%	Volatility 69%	Volatility 71%
Revenue Procedure 2002-13	$9.43	$12.19	$12.19	$12.19	$14.76
Black-Scholes (SFAS 123)	$3.00	$4.26	$5.82	$7.27	$7.48

This publication is intended to provide accurate and authoritative information on the subject matter covered. It is distributed with the understanding that the publisher and distributors are not rendering legal, accounting or other professional services and assume no liability whatsoever in connection with its use.

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