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April 2, 2002

Honorable Mark A. Weinberger
Assistant Secretary
Department of the Treasury
Room 1334 MT
1500 Pennsylvania Ave., N.W.
Washington, DC 20020

Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Revenue Procedure 2002-13

Dear Sirs:

I am writing on behalf of the Tax Section of the New York State Bar Association to suggest that the Treasury Department consider delaying the effective date of Revenue Procedure 2002-13, 2002-8 I.R.B. 549 (the "Revenue Procedure"), in order to allow sufficient time for the Revenue Procedure to be fully considered and commented upon. In the interest of time, I am sending this letter without its having undergone the normal approval process of the Tax Section's Executive Committee, although I have consulted informally with the members of the Executive Committee.

The Revenue Procedure was published in late February of 2002, during the same week that the Treasury Department released new proposed "parachute tax" regulations (the "New Proposed Regulations") under Sections 280G and 4999 of the Internal Revenue Code of 1986, as

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amended (the "Code"). The Revenue Procedure provides guidance (including new "safe harbor" rules) regarding the valuation of compensatory stock options for purposes of Code Sections 280G and 4999. The New Proposed Regulations take effect for payments contingent on a change in control that occurs on or after January 1, 2004, and provide for a comment period that expires June 5, 2002, with a public hearing scheduled for June 26, 2002. In contrast, the Revenue Procedure provides a stated effective date of April 26, 2002, although it contains a request for comments within the same time frame that comments are requested on the New Proposed Regulations: *i.e.*, by June 5, 2002.

The Tax Section expects to provide detailed comments on both the New Proposed Regulations and the Revenue Procedure prior to the June 5 deadline. We believe, however, that the government should give more immediate consideration to delaying the Revenue Procedure's effective date. Preliminary analysis of the Revenue Procedure and the Proposed Regulations suggests that the Revenue Procedure may give rise to potential issues (illustrated by the example that follows) that deserve further consideration. More basically, the Revenue Procedure is integrally related to the New Proposed Regulations, rendering it impossible adequately to evaluate either without considering the other. We therefore urge the Service to postpone the effective date of the Revenue Procedure until a reasonable period after the June 5, 2002 deadline for submitting comments, so that this guidance can be provided with the benefit of the comments requested for both the Revenue Procedure and the New Proposed Regulations. Alternatively, we would suggest that the Service indicate, pending further consideration, that the methodologies set forth in the Revenue Procedure and Rev. Proc. 98-34 (discussed below) are in fact "safe harbors" and not the exclusive method for valuing compensatory options.

Example Of Issues Raised by Rev. Proc. 2002-13

Hypothetical Facts: X is a senior employee of Target ("T"), which is acquired by Acquirer ("A") on June 1, 2002 in a transaction that constitutes a change of control for T for purposes of Section 280G (the "Acquisition"). The Acquisition is accomplished by the exchange of one share of A stock for each share of T stock. On the date of the Acquisition the value of a share of each of A and T stock is $40. Both companies are publicly traded on an established securities exchange.

On June 30, 2001, T had granted X 90,000 non-vested options (the "Options") to acquire a share of T common stock for $40 per share. The final maturity date of the Options was June 30, 2011. Apart from the Acquisition, the Options were scheduled to vest on June 30, 2004, provided that X was employed by T at such time. Pursuant to their terms, any vested Options would lapse if not exercised within 30 days following

termination of X's employment.

The Options vest pursuant to their terms in connection with the Acquisition and are exchanged for options to acquire A stock for $40 per share, which expire June 30, 2011 or, if earlier, 30 days following termination of X's employment. At the time of the Acquisition, it is expected that X will remain employed by A for a transitional period of one year or less, after which time he will retire. X in fact retires after ten months, and exercises his options 25 days later at a time when the value of A stock is $50 per share.

Analysis: Although Section 3.01 of the Revenue Procedure suggests that options may be valued using any method that is consistent with generally accepted accounting principles and the New Proposed Regulations, Section 3.02 appears to override this general principle by effectively mandating, for virtually all "compensatory options" with respect to publicly traded stock, the use of the modified Black-Scholes valuation approach required under Rev. Proc. 98-34, 1998-1 C.B. 983, or the more heavily modified Black-Scholes surrogate "safe harbor" proposed in the Revenue Procedure itself.

Consequently, it would appear that for purposes of Section 280G, the Revenue Procedure would require X to value the vested Options he receives in connection with the Acquisition using the valuation approach of either Rev. Proc. 98-34 or Section 4 of the Revenue Procedure. Under either approach, it would appear that X would be required to treat the Options as having a term that is substantially longer than their expected term of one year. Under Section 4.04 of the Revenue Procedure, X apparently would be required to assume that the vested Options had a term to maturity of 9 years (because term is calculated with reference to "the latest date on which the option will expire"). Under Section 4 of Rev. Proc. 98-34, X apparently would be required, in valuing the vested Options, to treat them as having a remaining term of either the "Maximum Remaining Term" (similarly to the Revenue Procedure) or the "Computed Expected Life," which is based on the weighted average life of options granted by the company during the year of valuation, as disclosed in the company's financial statements for that year in accordance with FAS 123.[1]

We are not experts in accounting, and therefore not in a position to comment on how the above situation should be accounted for under

[1] Because Rev. Proc. 98-34 is not written with changes of control in mind, it is not entirely clear how it would apply on the facts stated. Presumably one would look to the financial statements of A for 2002. Note, however, that the vesting of X's Options might have occurred some time prior to the Acquisition (e.g., upon the T shareholders' vote approving the Acquisition).

GAAP. We do note, however, that Rev. Proc. 98-34 states as a general principle that the valuation of an option should take account of the expected life of the option.[2] Nonetheless, as noted above, Rev. Proc. 98-34 requires the taxpayer, in determining an option's expected life, to use either the Maximum Remaining Term or the Computed Expected Life, neither of which permits evaluation of particular circumstances such as the expectation of a short remaining term of employment for X in the example above. This makes sense in the context of a safe harbor. However, to mandate use of such an approach for purposes of Section 280G would seem sufficiently debatable that a full comment period should be allowed before proceeding.

In the foregoing example, there are many different fact patterns that could form the basis for the expectation at the time of the Acquisition that X's employment would terminate within a year, thereby accelerating the exercise or lapse of the Options. For instance, there could be a contractual agreement between X and A stipulating the term of his employment; alternatively the expectation could informal, in which case it might be either jointly held by X and A or based on a unilateral and possibly confidential decision by one or the other. We express no view at this time as to whether or how the Revenue Procedure should distinguish among the various possible fact patterns. It is, among other things, in order to allow for fuller discussion of this issue that we recommend delaying the effective date of the Revenue Procedure.

Based on the preamble to the New Proposed Regulations, we understand the Service's position to be that mere reliance on the "spread" between option exercise price and fair market value of the stock at the date of a change in control is not an appropriate method of valuing options for purposes of Section 280G. Thus, on the facts stated, the Service presumably would not accept a valuation of zero for the vested Options. In suggesting that the Service extend the effective date of the Revenue Procedure, we do not mean to express disagreement with this aspect of the Service's position, or to imply that it should refrain from making this position clear prior to the effective date of the Revenue Procedure.

In light of all of the foregoing considerations, we recommend that the effective date of the Revenue Procedure be delayed until the issues it raises can be more fully considered. We would welcome the opportunity to discuss these issues further with the Treasury Department or Internal Revenue Service, and as mentioned above, look forward to submitting detailed written comments at a later date. Among other things, we expect

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[2] This principle is consistent with the description of financial accounting principles set out in Rev. Proc. 98-34.

to comment on the relative merits of a Black-Scholes approach and other possible valuation methods.

Respectfully,

Samuel J. Dimon
Chair

cc: Pamela C. Olson
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