

UNCERTAINTY REGARDING THE TAXATION OF STOCK OPTIONS PLANS

Share-based payment arrangements, usually named Stock Option Plans (SOPs), provide an efficient means of aligning interests between companies and their employees. In Brazil, however, agreements concerning SOPs lead to different labor, tax, and social security treatments based on how they are structured and thus require special attention until solid case law from Brazilian courts arise.

Encouragingly, although there is no specific regulation on the matter, Brazilian labor courts usually hold that plans in which employees take the risk of the fluctuation of the stock prices, paying for the option, have a commercial nature and not a labor one. Therefore, the difference between the fair market value of the shares on the exercise date and the exercise price granted to the individuals with vested options is not deemed a retribution for the services rendered. Consequently, the difference does not integrate their remuneration for purposes of calculation of employment pays such as Christmas bonus, vacation, and contributions to the Unemployment Labor Fund – FGTS.

On the other hand, Brazilian tax authorities have a much more restrictive approach regarding income taxation and social security contributions over employees' gains in SOPs. Broadly speaking, unless a given share-based payment is completely unrelated to the employee's services, it should be treated as compensation for services rendered for all tax and social security purposes, including the Withholding Income Tax (WHT) at up to 27.5%, Social Security Contribution to the National Social Security Institute (INSS) and other contributions on payroll, usually ranging from 20% to 31.8%, depending on the company's activities.

These taxes and contributions are usually charged on the positive difference between the shares' fair market value (FMV) on the exercise date and the value actually paid by the employee to purchase the shares, which is often lower than the former amount (e.g. shares' FMV on the granting date). This positive difference is the amount deemed by tax authorities as compensation for services performed.

An alternative view features share-based plans as stock transactions giving rise only to capital gains earned by the employees (subject to lower taxation from 15% to 22.5%), rather than ordinary service compensation subject to the taxes and contributions described above. Under this view the shares' purchase price paid by the employee (e.g. their FMV on the date of granting) would constitute the cost of acquisition of his/her shares, while the employee's capital gain would arise only on a subsequent sale of the shares for an amount exceeding the mentioned cost.

However, according to tax authorities and some administrative court precedents, in order for SOPs to be treated that way several requirements must be met, including (i) presence of risk, meaning that the employee's gain under the plan must be uncertain; (ii) employees must use his/her own funds to pay the exercise/purchase price of the shares, which must be equivalent to the FMV of the shares as at the date of the option's exercise; (iii) the employee's right to exercise stock purchase options must not be conditioned to his/her performance during the vesting period; (iv) employees' adherence to the plan must be optional and, after vesting, they should be able to decide the date of exercise and sale of the shares; and (v) granting of stock options must not be recurrent.

The condition described in item "ii" above – i.e. purchase price to be paid by the employee must be equal to the shares' FMV on the date of exercise – jeopardizes much of the SOP's advantage. In our opinion, provided that the other conditions mentioned above are met, if the price paid by the employee is not equal to the shares' FMV on the date of exercise but rather a lower amount such as their FMV on the date of granting, this per se should not be enough to justify taxation of this difference as service compensation, as intended by tax authorities and certain Brazilian courts.

The taxation of SOPs still awaits binding case law from Brazilian courts. Until then, or while no specific regulation is issued on this matter, companies must bear in mind the tax, social security, and labor risks of share-based plans and be extremely cautious in structuring any intended plan.

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