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THE TAX TREATMENT OF EMPLOYEE STOCK-OPTIONS: A BRAZILIAN PERSPECTIVE

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Abstract: This article presents an analysis of issues concerning the taxation of employee stock options plans (ESOPs). It examines a detailed study published by the Organization for Economic Co-operation and Development (OECD) regarding the tax treatment of stock options and incentive pay schemes in the OECD countries and compares its conclusions with the tax treatment of ESOPs in Brazil. The aim of this article is to illustrate the main conclusions of the analysis made by OECD based on the tax neutrality principle and to provide a specific description of the tax treatment of ESOPs in Brazil, showing how the discussions pointed out by OECD are being faced in the country. The conclusion, unfortunately, is that all the intricacies that arise when the companies decide to grant ESOPs listed by OECD also arise in Brazil, which combined with the fact that there are no specific regulations regarding the tax treatment of stock options, specially regarding the qualification of the income received by employees as stock options (if salary or only capital gains), introduces even more an undesired level of uncertainties.

Keyword: stock options; OECD; salary; capital gains

1. INTRODUCTION

The practice of granting a company's employee options to purchase the company's stock has spread through the business world. An official document published by the OCDE's Committee on Fiscal Affairs[1] states that, in the 1990s, stock options were a standard feature in most executive pay packages in countries like United States, Canada, Australia and the UK, and, in more recent years, their use has been

1 OECD (2006), The Taxation of Employee Stock Options, OECD Tax Policy Studies, No. 11, OECD Publishing, Paris, available at https://doi.org/10.1787/9789264012493-en, at 10.

extended to a larger set of countries, becoming a more common form of employees' compensation.

But what are stock options and what can we call Employee Stock Options Plans (ESOPs)? A stock option is the right to acquire a share from a given seller at a given moment or during a given period. In other words, stock option is a financial instrument that represents the right to buy a certain asset. The ESOPs, on the other hand, consists of a program that grants employees the right to acquire a determined number of shares of the employer's company at a designated price within a determined timeframe. Traditionally, the intention of these programs is to align employees' and employers' interests by providing a long-term incentive in which the benefits from its success will affect both parties (employees and employers).

Under an ESOP, therefore, stock options are granted to employees, but usually with certain conditions, marked by four different events, such as the granting, the vesting, the exercise and the sale of the shares acquired through the exercise of the options. The time of grant corresponds to the moment when the employee is given options to acquire shares, normally subject to a minimum holding period (vesting period). When the conditions under which the stock options were granted are fulfilled, the option is said to be "vested" and the employee has the right to exercise its options and acquire the share with the price already fixed (strike price). In some programs, after the vesting period, the employee can also sell the options immediately. In others, however, even after the vesting period, the employee is subject to another minimum holding period (called "lock-up").

In general, the popularity of stock options plans is justified by the economic argument already mentioned, that is, the stock options helps to align employee and shareholders interests and help to increase the benefits for the company. However, there is also another important aspect that is really taken into consideration when the company decides to grant the right to employees to acquire its shares at a given moment or during a given period at a fixed price, that is the advantages from a tax perspective, because, in some cases, stock options also enable the companies to compensate executives and employees in a more advantageous way than paying a cash salary.

In this context, this article makes an analysis of issues concerning the taxation of ESOPs. Based on a detailed study published by OECD regarding the treatment of stock options and pay incentive schemes in the OECD's countries, section 2 analyses the main conclusions concerning the special tax treatment of ESOPs and the tax neutrality principle. The analysis of the stock options tax treatment in OECD's perspective is important not only to comprehend how the countries deal with the ESOPs' taxation, but also to understand the existing discussions on the matter. The conclusions show that there are a number of issues, mainly regarding the type of income (if salary or not), the timing of taxation and the applicable taxes, which remains unclear even after so long.

Section 3 is a retrospective of the ESOPs in Brazil, which, in the recent years, are also becoming a more common instrument of employee' compensation. The aim of this section is to compare the OCDE's conclusions with the tax treatment in Brazil, demonstrating that the same discussions involving the taxation of stock options plans exists in the country, with an extra problem, that is the lack of specific regulations regarding the subject and the fact that the general rules regarding taxation of employee benefits still raises a lot of issues yet unsolved by Brazilian law and jurisprudence. Section 4 will present a conclusion to this article.

2. THE OECD'S VIEW REGARDING THE TAXATION OF STOCK OPTIONS PLANS

The main purpose of this Chapter is to present the conclusions from the detailed study published by the OECD's Committee on Fiscal Affair regarding the possibility of a special tax treatment for employee stock option plans and the application of the tax neutrality principle. Special attention must be given to the referred principle, which was assumed as being violated when the choice of granting stock options became more advantageous for purposes of reducing taxes than the payment of the ordinary salary.

2.1 The OECD's Tax Policy' Studies

As previously mentioned, in the recent years, the use of stock options plans has been extended to several countries, becoming a more common instrument for employee's compensation. However, although commonly used, the taxation of stock options can be complex, as there are a lot of factors that determine how much is taxable and when (i.e., in which moment) it is supposed to be taxed.

In 2006, the OECD published a study presenting an analysis of issues that arise from the taxation of the employee stock option plans. In the beginning of the publication, it is stated that the study represents the output of a project that was initiated by the OECD's Committee on Fiscal Affairs in 2001 and that it is divided into two main parts, related to domestic aspects of the countries members and to international issues[2]. At that time, the discussions involving stock options were already relevant, because the ESOP's were considered a common

2 *Ibid*, at 3.

component of remuneration packages in multinational enterprises. However, more than ten years later, the same issues pointed out by the referred publication still exist and, at least from a Brazilian perspective, will still remain for a long time.

The main challenge according to the OECD was the fact that the benefits from an employee stock options are taxed in different ways in different countries, which makes the discussions even more complex and difficult to define exactly how the ESOPs are and must be taxed[3]. The conclusions show that there are a number of factors that determine how and when an employee stock option will be taxed, but each country has its own way of defining the treatment. The problem is that there's also a number of tax treaty issues arising from employee stock options, mainly concerning to the qualification of the income (if stock options are considered compensation income or capital income), the applicable taxes and charges (income tax, capital gains tax and social security contributions), the timing of taxation (grant, exercise or disposal of shares) and the treatment at corporate level (if the cost of the stock options can be deducted or not from corporate income)[4].

After considering several aspects regarding the taxation in different countries, OECD proposes its conclusion of how stock options must be qualified and taxed based on the tax neutrality principle, averting the two main arguments presented by literature in favour of a special taxation of employee stock options. First, the economic one, that defends that the stock options can mitigate the main problem agent in corporate governance by being an effective mechanism for aligning the interests of managers more closely with those of shareholders. In this sense, OECD states that this argument has been scrutinized by a number of empirical studies, which concluded that stock option, rather than contributing to a solution, are part of the corporate problem. Secondly, the argument based on (i) motivation and productivity of employees, (ii) personnel recruitment and retention and (iii) capital and liquidity-related reasons[5].

According to OECD, stock option can create a stronger sense of involvement in employees, making them more interested in the value of the company and inducing them to increase their productivity, nonetheless, it also happens in others pay incentive schemes. As to the other two points, OECD recognizes that they are consistent, because stock options can be an effective instrument in attracting and retaining personnel specially for young and growing firms, because otherwise employees would prefer to work in larger companies, and also play an important role in the presence of capital and liquidity constraints,

3 *Ibid,* at 12.
4 *Ibid,* at 16-17.
5 *Ibid,* at 11.

allowing companies (specially young firms and start-ups) to compensate their employees without immediate cash payment. In this regard, OECD admits that the conclusions on the appropriate level of taxes to be levied on stock options and on possible preferential tax treatments are difficult to draw, but the simple fact that stock options have desirable characteristics (such as the ones described) is not sufficient to justify special tax treatment[6].

The conclusion, therefore, is that an efficient tax treatment of stock options must respect the principle of tax neutrality, specially concerning the choice of granting stock options and paying ordinary salary. But what can we consider as “tax neutrality”? The question deserves further clarification.

2.2 The Tax Neutrality principle and the OECDs’ concept in this regard

In order to have a clear view of the way OECD sees the taxation of ESOPs, is important to provide a detailed definition of the tax neutrality principle. Douglas A. Kahn defends that the term “tax neutrality” has at least two different concepts[7]. In its most common sense, it refers to tax provisions that conform to an ideal tax system. He brings the lessons of Professor Stanley Surrey, who has embellished the tax neutrality concepts and characterized tax provisions that violated the concept of neutrality and that benefit some taxpayers as “tax expenditures”[8]. According to Professor Surrey, a failure to tax someone according to neutral principles characterizes a government expenditure, which is essentially identical to a direct outlay of government funds. In other words, a preferential tax treatment is identical to the Government making a direct payment to a specific group (the beneficiaries of the special tax treatment).

The other concept of the tax neutrality presented by Douglas A. Kahn is that, sometimes, the tax neutrality is used to describe a tax system that does not create a bias that could influence a taxpayer to choose an investment or course of action over another. The example given to illustrate this point reflects the affirmative, i.e., if the tax levied over the income from rental realty is less than the tax levied over the same amount of income from bonds, the tax law will distort the market

6 *Ibid,* at 11.

7 Kahn, Douglas A. “The Two Faces of Tax Neutrality: Do They Interact or Are They Mutually Exclusive?” N. Ky. L. Rev. 18 (1990): 1-19, available at https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1318&context=articles, at 1.

8 *Ibid,* at 4-6.

choice between investing in realty or in bonds[9]. In this sense, a tax neutral provision would be the one that allows the choice of investment or action to be made based on market or personal considerations without influence from tax laws. This approach of tax neutrality, however, would lead to the question whether there is a true violation in providing stock options plans with special tax treatment.

It is important to highlight that Douglas A. Kahn concludes that tax neutrality is not a true principle. He states that the so-called principle of neutrality is merely a recognition that the cost of such a tax influence is sometimes too great because considerations about economic or social policy dictate that some specific choice should be made based on market or personal grounds[10].

Returning to the OECD's view, is possible to say that it rests on the first concept presented by Douglas A. Kahn in said article, since the tax neutrality is used to justify the impossibility of granting special tax treatment to stock options plans. According to OECD, an efficient tax treatment of stock options is the one that provides no tax-related incentive for a company to either increase or decrease the number of employee stock options that it grants, and that is neutral with respect to the choice between granting stock options and paying ordinary salary[11]. The OECD's conclusion is that to ensure neutrality between the taxation of stock options and ordinary salary, the tax system must combine the allowance of stock options costs as a company tax deduction, and the equal treatment of stock options benefits and ordinary salary at the personal level[12].

Despite arguments to the contrary regarding the special tax treatment of ESOPs, the OECD makes a clear statement that the objective of the study was to present a non-perspective analysis based on the principle of neutrality, in order to provide a useful benchmark for policymakers[13]. However, the study just started the arguments, leaving the question of whether any non-neutrality is desirable to the judgment of individual countries.

3. THE BRAZILIAN PERSPECTIVE OF THE EMPLOYEE STOCK OPTIONS TAXATION

This chapter will present the provisions of stock options plans in Brazil. First, it examines the main aspects regarding the national regulation of the subject. Then, it also compares the OECD's conclusion

9 *Ibid,* at 11.
10 *Ibid,* at 15.
11 OECD, *supra* at 12.
12 *Ibid,* at 32.
13 *Ibid,* at 17.

with the tax treatment in Brazil.

3.1 The tax treatment of stock options plans in Brazil

In Brazil, the companies create their stock option plans in accordance with Article 168, Paragraph 3 of Federal Law 6,404 of December 15, 1976, as follows:

"Article 168. The bylaws may authorize capital increases without amendment to the bylaws.

(…)

Paragraph 3. The bylaws may provide that the corporation may grant a share purchase option to its officers or employees, or to individuals rendering services to the corporation or to a corporation under its control, within the limits of its authorized capital and in accordance with a plan approved by a general meeting".

Even though the aforementioned Law exists for more than forty years, the history involving the taxation of ESOPs in Brazil is relatively recent. In fact, when it comes to the qualification of the income for purposes of taxation, there is no specific regulation on this matter. As a consequence, the tax treatment of stock options plans depends basically on a case-by-case analysis. The problem, therefore, arises from a discrepancy between the positions normally taken by Tax Authorities and by Judicial Courts, especially in light of the Labour Courts' jurisprudence.

As a rule, Brazilian legal entities and their employees are required to pay social security contributions over the amount paid by the employer as compensation for the employees' work (remuneration). However, due to the lack of legal provisions, the question whether stock options granted under the companies' plans should be treated as compensation income or investment income remains unclear.

The first decisions regarding stock options in Brazil were ruled by Labour Courts, which have defined the parameters to be observed in order to differentiate stock options from compensation income (i.e., to avert the qualification of stock options as remuneration). First, the beneficiaries must adhere to the ESOPs voluntarily. Second, it is indispensable to have an onerosity aspect in the contract to be sign between the company and employees. In other words, the beneficiaries need to invest their own financial resources to exercise the options granted. Third, the existence of investment risk (if the stock options are exposed to market risks). Hence, it can be said that Labour Courts in Brazil accept the commercial nature of stock options if companies observe the three parameters mentioned. However, although important to stablish the grounds of what is considered remuneration or not (even for tax perspective), the Labour Courts are competent to adjudicate disputes concerning only labour relations (and not tax causes) and, because of that, Tax Authorities not always respect the parameters established by them.

Recently, Tax Authorities started to pay more attention to stock options plans and issued several tax assessments in order to demand social security contributions from companies that granted stock options to employees assuming that the real intention of the company was to pay an uncovered salary and, therefore, avoid taxation. One of the arguments given in favour of the qualification as compensatory income is the fact that employees are allowed to buy shares at prices lower than market value and then sell them later at higher values.

Since 2013, the Brazilian Administrative Tax Court ("CARF") has been adopting a more strict orientation regarding the qualification of ESOPs than the ones set forth by Labour Courts and, in most of the tax assessments issued, the stock options were considered to be part of the beneficiaries' remuneration, subject to the same taxes levied over ordinary salary. However, it is important to highlight that CARF recognizes in their decisions that stock options may also have an investment purpose, and, in that case, the social security contributions would not be due. Nevertheless, in order to consider stock options as investment income, is necessary to demonstrate the existence of risk and the uncertainty as to gain, which are concepts undefined by Brazilian law and really difficult to prove. Therefore, even though the difference between stock options and compensation income according to the parameters fixed by Labour Courts is accepted, the decisions ruled by CARF suggest that, in the Court's view, is almost impossible to create an ESOP dissociated from the employee's remuneration.

From CARF's perspective, therefore, the qualification of stock options depends on the structure of the plans created by the companies and the benefits given to employees. Usually, as previously mentioned, the Courts recognize that stock options are different from ordinary salary based on the argument of the existence of the risk. Since there's no certainty of gains, the simple fact that the ESOPs are granted during a work contract (in theory) would not be sufficient to qualify the eventual gain as ordinary salary, since the employee may lose money depending on the stock value. What is unacceptable, to CARF, is the inexistence of risks and the certainty of gains for the employees. Finally, since there are no legal provisions regarding the definition of risk for tax purposes, there is always a good reason, specially on the administrative sphere, to defend the remunerative nature of the income and to demand the payment of social security contributions.

The judicial Courts competent to adjudicate tax causes, directly or indirectly related to the Federal Union, and to analyse the validity of tax assessments issued by Tax Authorities have not yet given a definitive decision on the matter. There are very few decisions rendered and the final conclusion is yet unknown, but, until know, by examining them, it seems that the interpretation given is closer to the one settle by Labour Courts.

In a case involving the Brazilian subsidiary of the Swedish company Skanska, for example, the company presented its defence against the tax assessment issued based on the parameters fixed by Labour Courts and argued that the employees voluntarily used their own money to buy the shares and that the shares are subject to the same market risks as others with no guarantees of profits. The Federal Court considered that the Skanska stock option program is a contractual agreement between the company and its employees and, therefore, ruled in favour of the Company. According to the Court, the stock options were not part of employee's remuneration, but of a mercantile contract between two parties (company and employees), and, in this case, not subject to social security contributions[14].

Despite the lack of specific regulations regarding the qualification of stock options for purposes of taxation, is important to point out that Federal Law 12,973 from May 13, 2014, allows the companies to deduct the stock options costs from the corporate income base. Therefore, considering the above, if certain conditions are respected (such as voluntarity, onerosity and risk), is possible to say that in certain conditions or in certain schemes, Brazil grants preferential tax treatment to stock options, at the same time allowing deductibility at the corporate level.

However, due to the uncertainties in Brazilian law and jurisprudence, even if the parameters fixed by Labour Court's jurisprudence (voluntarity, onerosity and risk) are observed, the companies must be aware of the risk of being questioned by Tax Authorities and eventually having tax assessments issued to demand social security contributions.

3.2 The OECD' conclusion and the Brazilian perspective

Contradicting the general conclusions of OECD of how stock options must be taxed, in Brazil is possible to defend a special tax treatment for employee stock option plans without facing the tax neutrality principle, which is not really considered in the discussions on the tax regime applicable to stock options. Even though there are still no specific regulations regarding the qualification of the income, in general, the benefits obtained with ESOPs are taxed in a different way than ordinary salaries, subject only to capital gains tax. However, due

14 Regional Federal Court for the Third Region (TRF 3). Appel n. 0021090-58.2012.4.03.6100/SP, of April 08, 2016.

to the uncertainties and the risk of receiving tax assessments issued by Tax Authorities demanding social security contributions, many companies have already decided to consider ESOPs as part of the employee remuneration and, in this case, the treatment adopted is in line with OECD's position.

Besides from the qualification of the income, the other issues pointed out by OECD, mainly concerning to the timing of taxation (grant, exercise or disposal of shares), are also unresolved in Brazil. As already mentioned, there are no specific regulations on the matter and even the qualification of the income (if stock options are considered compensation income or capital income) is still being defined according to the jurisprudence. Regarding to the timing of taxation specially, unfortunately, is not possible to determine exactly what will be the outcome of the jurisprudence.

In this context, the necessary conclusion is that the number of issues that arise from the analysis of the tax treatment of stock options in OECD's countries also exists in Brazil. However, without facing the tax neutrality principle. It is not clear yet what would be the true nature of the income and the final decision of Brazilian Judicial Courts, but, for now, is possible to defend the difference between stock options and remuneration and tax the first ones in a more advantageous way than ordinary salary, since it is subject to market risks not faced by compensation incomes.

4. CONCLUSION

This article presents the main conclusions regarding the special treatment of ESOPs in the OECD's context and the Brazilian perspective about the subject. The goal was to analyse the detailed study published by OECD in order to understand the intricacies of stock options taxation and the issues that arise for beneficiaries and companies, presenting how, in OECD's view, the stock options must be qualified and, in consequence, taxed.

According to the conclusions set forth by OECD, an efficient tax treatment of stock options must respect the principle of tax neutrality, specially concerning to the choice of granting stock options and paying ordinary salary. The important thing for OECD is to have a tax treatment that provides no tax-related incentives for a company that decides to grant stock options to its employees and that is neutral regarding the choice of either granting stock options or paying ordinary salary. Regardless of the conclusions, OECD clearly states that the objective of the study was just to present a non-perspective analysis based on the principle of neutrality, leaving to each country the decision whether such a principle must be observed or not.

In Brazil, the tax neutrality principle is not really analysed when it comes to ESOPs and, in general, stock options are treated differently than ordinary salary and other forms of long incentive schemes when it comes to taxation. The benefits of stock options plans are subject, for example, to the same taxation as capital gains, which do not include the social security contributions. However, all the aspects regarding stock options in the country derive from jurisprudence, which still oscillates a lot. The lack of specific regulations on the matter turns the discussions around stock options uncertain for taxpayers (beneficiaries and companies) and difficult to draw.

Overall, the evolution of stock options in Brazil shows that OECD's conclusion based on the neutrality principle is not really discussed in the country. The difference between stock options and ordinary salary is considered to be accepted when certain aspects are observed by the companies, such as voluntarity and onerosity, and when is clear the presence of risks taken by the beneficiary. If such aspects are demonstrated, it is possible to defend that the stock options granted by companies arise from a mercantile contract, with no connection to the labour relation and, therefore, subject to different taxation as ordinary salary.

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