Equity-Based Compensation: Notes from Brazil

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Stock option plans (SOPs) are one of the most common forms of equity-based compensation and serve as an important incentive mechanism for corporate employees, executives, and service providers (referred to in this article as "beneficiaries").

The underlying rationale of SOPs is the expectation that the shares subject to the options will appreciate over time, allowing beneficiaries to profit from the difference between the strike price, which is fixed in advance, and the market value of the shares at the time of exercise.

SOPs often include vesting conditions, such as a minimum period of service or the achievement of performance targets. Once the vesting period has elapsed and any vesting conditions are met, beneficiaries acquire the right to exercise their options by paying the strike price set under the plan.

Even before Brazil adopted international accounting standards, the Brazilian Institute of Independent Auditors, in a joint statement with Brazil's securities and exchange commission of Brazil (CVM – *Comissão de Valores Mobiliários*), classified SOPs as a form of equity-based compensation. Companies were required to disclose the nature and terms of their SOPs, their accounting treatment, and the number and value of shares issued under the plans.

Nonetheless, there was no obligation to reflect SOP-related transactions directly in the company's financial statements, and, in fact, it was common for companies to record the impact of SOPs on equity only once the options had been exercised and the corresponding shares issued. As a result, the legal and accounting information often appeared years after the plan was established, reflecting amounts fixed at a sometimes distant moment in the past.

In the fields of tax and employment law, however, SOPs had already generated much dispute. The central issue was whether SOPs should be treated as

(i) *commercial transactions*, having the same legal nature as call options traded on stock markets, or stock warrants, for example, or

(ii) *remuneration*, akin to a cash bonus paid to company executives.

If classified as commercial, only the capital gain realized on the sale of shares acquired through the SOP would be subject to income tax, and the acquisition cost for tax purposes would be the strike price paid. Conversely, if considered remuneration, the benefit would be subject to payroll charges, including social security contributions, and income tax would be payable by the beneficiary on the value of the shares at time the option was exercised. That value would then serve as the acquisition cost for calculating any capital gain if the shares were later sold by the beneficiary.

Over the course of many taxpayer appeals, the position of the Administrative Tax Appeals Council (CARF – *Conselho de Administração de Recursos Fiscais*) eventually coalesced around the view that SOPs should be considered to be remuneration, unless the beneficiary was subject to conditions similar to those found in arm's-length transactions:

(i) exposure to share price volatility;

(ii) market-based pricing of shares subject to the plan; and

(iii) voluntary participation in the plan.

Technical Pronouncement No. 10 by Brazil's Accounting Pronouncements Committee (CPC – *Comitê de Pronunciamentos Contábeis*), approved on February 3, 2010, aligned Brazilian public companies with international accounting standards under IFRS 2. CPC 10 requires companies to recognize SOP-related amounts at the time options are granted, treating the benefit as a form of compensation to be recorded as an expense for services rendered, with a corresponding entry in the equity section.

Next came legislation to govern the deductibility of equity-based compensation for the purposes of Brazil's corporate income taxes. The rules under article 33 of Law 12.973/2014 refer to "remuneration for services rendered by employees or similar" granted under equity-based compensation.

With the changes introduced by CPC 10 and article 33 of Law 12.973/2014, the tax authorities stepped up audits and assessments against both companies and beneficiaries, looking to collect social security contributions and income tax.

In response to this uncertain situation, many companies began turning away from SOPs toward other incentive mechanisms, such as restricted stock (which cannot be sold until vesting conditions are met) and phantom stock plans (which provide cash payments based on share price performance).

However, a recent decision by Brazil's Superior Court of Justice (STJ – *Superior Tribunal de Justiça*, the highest court in non-constitutional matters) may shift the landscape once again. In a binding ruling on the question of whether, from a legal point of view, stock option plans should be classified as commercial transactions or remuneration for services (Repetitive Appeal Theme 1.226), the STJ held that they are commercial in nature, and only the capital gain on sale of the shares should be taxed. As a result, the court rejected the notion that income tax should be levied at the time stock options are exercised, since the beneficiaries do not receive any benefit at that stage that can be classified as remuneration.

Still, the STJ's decision may not fully resolve the debate. A close reading of the decision reveals that classification as a commercial transaction still depends on the specific facts of each case, and particularly whether the conditions identified by CARF (payment of fair value, exposure to market risk, and voluntary participation) are present. Regardless, the ruling represents a significant, positive shift in the precedents, and may prompt companies to revisit how they structure equity incentives for their teams.

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