Some thoughts on the payment of incentive rewards

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The Employment Reform introduced by Law 13.467/2017 amended article 457 of the Consolidation of Labor Laws (CLT – Consolidação das Leis do Trabalho, Brazil's labor code) to provide that amounts paid as rewards (prêmios), even if they are paid on a regular basis, do not form part of employees' compensation, do not become a part of their terms and conditions of employment, and are not subject to payroll charges of any kind. Paragraph 4 of the article defines rewards (prêmios) as "gratuities given at the employer's discretion in the form of goods, services, or amounts of money to an employee or group of employees, by reason of performance superior to that ordinarily expected in the exercise of their activities."

According to the provisions transcribed above, the requirements that must be met in order for an amount to qualify as a reward are: (i) discretionary payment by the employer; (ii) by reason of performance above what would normally be expected; to (iii) an employee or group of employers; without restriction as to (iv) how regularly the amount is paid.

From a tax perspective, Law 13.467/2017 also amended article 28 of Law 8.212/1991 (the Social Security Organization and Financing Law) to include subparagraph 9(z), which provides that "rewards and allowances" are not part of salary for contribution purposes. Thus, by express provision of law, social security contributions do not attach to amounts paid as rewards, and the CLT makes it clear that other payroll charges such as severance guarantee fund deposits (FGTS) do not apply to rewards, although rewards are subject to income tax.

These changes were welcomed by employers when the Employment Reform came into effect, because they made it possible to reward employees who made significant contributions to the company's growth and profits without adding to the employer's payroll charges.

In practice, however, implementing the CLT's provisions on rewards has generated considerable uncertainty because most of the criteria that determine when an amount is a reward refer to broad concepts with a significant subjective element, which the Labor Courts have not yet had the opportunity to refine.

Provisional Measure 905/2019 sought to clarify some of the open questions around the payment of rewards that had led to varying interpretations, by providing, for example, that payment of rewards was valid regardless of the form or means used to fix the amount of the reward. The Provisional Measure was not converted into ordinary legislation, however, and has lapsed.

To date, the tax authorities have expressed their position on the scope and interpretation of the rewards under the Employment Reform in two tax rulings, COSIT Tax Ruling no. 151 (May 14, 2019) and DISIT/SRRF01 Tax Ruling no. 1009 (June 4, 2019). In those rulings, the Federal Revenue Service of Brazil (RFB – *Receita Federal do Brasil*) takes the position that to be excluded from social security contributions, rewards (i) must be paid only to employees, either individually or collectively, and not to non-employee service providers; (ii) must be paid in money or in the form of goods or services; (iii) must not be paid by reason of a legal obligation or an express agreement (such as an employment agreement, collective agreement, or company regulation), in which case they no longer constitute a discretionary gratuity; and (iv) must relate to superior performance, and thus the employer must demonstrate, by objective means, the expected level of performance and how the employees' performance exceeded the expected level.

According to the RFB's understanding of the law, the mere fact that a reward is contemplated in an agreement made between employer and employee will change the nature of the reward, making it subject to payroll charges, including social security contributions. Under this interpretation, the best way of paying a reward is to surprise employees who were not expecting a reward but nonetheless performed above the expected level.

Arguably, the RFB's interpretation is too strict, given that the CLT does not refer to elements such as the absence of any advance agreement and documents to prove ordinary and superior performance as conditions for the exemption from payroll and social security charges. Nonetheless, since the courts have not yet issued any decision on the question, it is impossible to determine, with any certainty, the effective scope and interpretation of the concept of a reward, or how rewards will be treated for labor and social security purposes.

Although the Labor Courts may be more flexible in classifying a given payment as a reward for the purposes of labor payroll charges such as FGTS, the recommended course of action is to comply with the tax authorities' requirements until the courts have established a clear position on the legal nature of rewards and their payroll consequences, since as a rule the contingent liability related to social security contributions is greater than the savings from a purely labor/employment perspective. The conclusion is that, even five years after the Employment Reform, for a reliable classification of discretionary payments as rewards within the meaning of article 457 CLT, employers should assess in advance their reasons for making the payment, in order to minimize the risk of potential liability.

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