

Stock Option Plans and the next chapters in the search for legal certainty

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Stock Option Plans (SOPs) began to be used in the 1990s. They were conceived of as a commercial instrument that offers the opportunity to acquire shares in the company for determined or determinable price, within a fixed period, designed primarily to align the interests of the company's executives and employees with the company's own interests.

From a tax point of view, around 15 years ago, the Brazilian Federal Revenue Service began issuing tax assessments treating SOPs as a form of remuneration, setting off widespread debate over the legal nature of SOPs in the Administrative Tax Appeals Council (CARF – Conselho Administrativo de Recursos Fiscais) and, more recently, in the Federal Regional Courts (TRFs – Tribunais Regionais Federais).

Although CARF has taken the position that an SOP can be commercial in nature, based on the features of each plan, in practice very few tax assessments have been canceled at the administrative level on the grounds that they are a commercial instrument, not a type of remuneration.

In the Federal Courts, decisions have been more favorable to taxpayers, with SOPs often being found to be commercial in nature, but there is still some fluctuation in the courts' position.

In an attempt to give SOPs greater legal certainty, article 33 of Law 12.973/2014 provides that companies are entitled to deduct the fair value attributed to "share-based payments", although the provision does not address the question of what taxes, if any, attach to such "payments".

In this context, many companies have decided not to adopt SOPs, and opted for other long-term incentives for their executives and employees, even if those incentives are clearly remunerative in nature. Of course, it is not just the legal (un)certainty over tax issues that determines a company's choice of one incentive model over another, but it is certainly an important element in the decision.

Currently, there are two initiatives that aim to reduce the legal uncertainty that surrounds SOPs, one in the courts and the other in Congress.

In the courts, the Superior Court of Justice (STJ – Superior Tribunal de Justiça, Brazil's highest court on non-constitutional issues) will decide appeals REsp 2.069.644/SP and Resp 2.074.564/SP under the "repetitive appeal" system, which means that the court's ruling in the appeals will be binding on all lower courts in cases that deal with the same issue. The question of law or the "theme" to be decided by the STJ is "to define the legal nature of plans giving executives options to purchase stock in companies (stock option plans), and

whether they are linked to contracts of employment (remuneration) or are strictly commercial, in order to determine the applicable income tax rate and the time at which income tax attaches" (Theme 1226).

In ruling on Theme 1226, the STJ will have to establish criteria for determining whether an SOP is commercial or remunerative in nature, but will not come down on one side or the other: In the absence of a specific provision in the legislation, the legal nature of SOPs must be determined on a case-by-case basis, in light of the features of each plan.

In Congress – and the legislative front could be more effective in removing the legal certainty around SOPs and making them more attractive to companies – Bill of Law 2724/2022 is worth noting. This proposal for a Legal Framework for Stock Options has already been approved by the Federal Senate and is currently before the Chamber of Deputies.

The Bill of Law expressly provides that SOPs are commercial in nature. According to the Bill, they "[are] not incorporated into employment contracts nor [are they] subject to any employment or social security charge or tax." The Bill reflects some terms and conditions for SOPs in line with market practice, such as:

- a vesting period of at least 12 months before the option can be exercised;
- a pre-fixed exercise price, which does not have to reflect the market price of the shares;
- the possibility of provisions that require beneficiaries to remain with the company for a certain amount of time, establish lock-up periods, and fix individual or collective performance targets for granting, acquiring and/or exercising options;
- voluntary participation in the plan.

Each of these features, together with others addressed in the Bill, has generated disputes, particularly before CARF. In our view, legislation along the lines of Bill PL 2724/2022 is essential to settle the controversy around SOPs.

These two initiatives set the scene for the next chapters in the SOP story. With luck, they will put an end to a debate that gone on for many years, and give companies the confidence needed to resume using this effective instrument for aligning interests.

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