Spain:
Supreme Court overrules regulation on stock option gains

In a recently published decision, the Spanish Supreme Court has ruled that one of the requirements to benefit from preferential income tax treatment on stock option gains does not comport with the language in the Personal Income Tax Act (PIT Act) and, therefore, is illegal.

Since 2003, the PIT Act has provided for a 40% reduction in the amount of stock option gains subject to Spanish income tax provided the income is considered "irregular income." The 40% reduction is only applicable to stock option awards, and, for the income to qualify for the preferential tax treatment, it must be generated over a period of at least two years and the income may not be recurrent or periodic. Regulations promulgated under the PIT Act have sought to provide clarity on how option awards and exercises can satisfy these conditions. According to the regulations, to benefit from the 40% reduction:

1. The option award giving rise to the gain must have a grant-to-exercise period of more than two years; and
2. The employer's plan must not allow stock option awards to be granted annually.

The second requirement has historically presented an obstacle for employees seeking preferential tax treatment in Spain. Since stock options typically vest over several years, thereby delaying the employee's exercise, these awards will generally satisfy the first test under the regulations. However, employers also tend to grant options on an annual or more frequent basis and, therefore, the awards will often fail to satisfy the second requirement for preferential treatment. In sum, under the regulations, the frequency of award grants, rather than the frequency of award exercises, has often been the dispositive factor in determining an employee's eligibility for the 40% reduction.

Supreme Court decision

In its decision reached on 30 April 2009, the Supreme Court held that the second requirement in the regulations (no annual grants by the employer) is unsupported by the language in the PIT Act itself and, consequently, is illegal. The PIT Act refers to "income" and the frequency with which an employee receives stock option income. The Court found that, since the second requirement in the regulations focuses on the frequency of stock option grants by the employer, rather than the exercise and income recognition by the employee, the requirement is irrelevant in determining whether the tax benefit should apply.

As a result of the Court's decision, employees are now entitled to apply the 40% reduction, even where options have been granted annually, provided the income is not deemed to be recurrent or periodic. The new guidance implies that an employee may be able to make multiple exercises within the same year without violating the requirement that the income be neither recurrent nor periodic. On the other hand, exercises in consecutive years will be considered recurrent and will disqualify the employee from receiving the tax benefit.

This is the second time the Court has addressed a PIT regulation in this area over the past two years. Before 2008, the PIT regulations required a minimum two-year grant-to-vest period for an option award to qualify for the 40% reduction. The Court similarly found that requirement illegal, which resulted in the current minimum two year grant-to-exercise requirement.

Impact on employees and employers

As noted above, although the Court reached its decision in April, the full opinion was published only recently. As such, the PIT regulations have not yet been rewritten by the Minister of Finance, and the Parliament has not yet indicated whether changes to the statute are forthcoming. In the meantime, it is expected that the tax authorities will abide by the Court's decision and disregard the no-annual-grants requirement in the regulations.

Pending further legislative or regulatory guidance, employers granting option awards annually may choose between one of two approaches to income tax withholding:

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- Under the more conservative approach to withholding, employers may continue to withhold on the full amount of the award, rather than the reduced amount an employee may now be entitled to. Where an employer chooses this approach, the employee can claim the income reduction benefit on his/her year-end return and request a refund;
- Alternatively, employers may immediately take the Court's decision into account and begin withholding on the reduced amount. The formula for calculating the income reduction and corresponding tax benefit requires consideration of several factors, and a tax professional should be consulted.

Employees who did not benefit from the preferential tax treatment in the past, with respect to previously exercised options, may be able to claim a refund by filing an amended return. The amended return must be filed within four years of the end of the relevant tax year.

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