

Global Rewards Update: Spain

September 2009

SPANISH SUPREME COURT OVERRIDES PERSONAL INCOME TAX (PIT) REGULATION CONCERNING STOCK OPTION GAINS

BACKGROUND

Since 2003, under certain circumstances, The Spanish PIT Act ("Act") has provided for a 40% reduction in the amount of stock option gain subject to Spanish income tax where the income is considered to be "irregular income". The 40% reduction is only applicable to stock option awards, and the Act provides two requirements which must be met in order for income to qualify for this preferential tax treatment:

1. The income is generated over a period of at least 2 years; and
2. The income is neither recurrent nor periodical.

The PIT regulations promulgated under the Act have sought to provide clarity on how option awards and exercises can satisfy these conditions. The regulations stated that, 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 2 years; and
2. The employer's plan must not allow stock option awards to be granted annually.

This second requirement under the regulations 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 regulations' second requirement for preferential treatment.

In sum, under the regulations, frequency of award grants, rather than frequency of award exercises, has often been the dispositive factor in determining an employee's eligibility for the 40% reduction.

SUPREME COURT DECISION

On April 30, 2009, the Supreme Court ruled that the second requirement in the regulations (no annual grants by the employer) was unsupported by the language in the Act itself and, consequently, is illegal. The 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 exercises 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 on an annual basis, so long as the income is not deemed to be recurrent or periodical. 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 periodical. 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. Prior to 2008, the PIT regulations required a minimum 2 year grant to vest period for an option award in order to qualify for the 40% reduction. The Court similarly found that requirement illegal, which resulted in the current minimum 2 year grant to exercise requirement.

IMPACT ON EMPLOYEES AND EMPLOYERS

While the Court reached its decision in April, the Court's full opinion has only recently been published. As such, the PIT regulations have not yet been rewritten by the Minister of Finance, and the Parliament has not yet indicated whether any 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.

Employer Withholding

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

- Under the more conservative approach to withholding, employers may continue to operate withholding on the full amount of the award, rather than the reduced amount which the employee may now be entitled to. Where an employer chooses this approach, the employee can claim the income reduction benefit on their year-end return and seek a refund.
- Alternatively, employers may immediately take into consideration the Court's decision 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.

ACTION

- Employers should consider the Court's decision when calculating the relevant withholding tax. The 40% reduction on the taxable gain may now become applicable, within limits, where options had been granted annually.
- Employers should also continue to monitor employees' exercises of option awards. Where an employee has recognized option income in the prior year, the current year's option income will be deemed recurrent and withholding should be operated on the entire gain.
- Employers should reconsider their policy of making non-annual grants.
- 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 4 years of the end of the tax year in question.

People to Contact

For assistance in this matter or any other issue related to the operation of your global rewards plans, please contact your local Deloitte global rewards consulting services advisor or email us at: globalequity@deloitte.com and a global rewards consultant will contact you.

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