Supreme Court leaves fate of stock options undecided

On 4 February 2005, the Belgian Supreme Court, the *Cour de Cassation* has handed down a decision that will be quoted by the tax authorities in many litigations to come.

The tax regime for stock options

Stock options can be taxed at one or more different time (this is indicated as 'the taxable or chargeable event') :

(1) The first taxable event is the **grant** of the option, i.e. when the employee receives the right to buy a share;

(2) The second taxable event is the **exercise** of the option, when the employee uses his option to buy a share;

(3) A third taxable event can be when the beneficiary makes a **capital gain** on the shares he acquired at the time of the exercise. This last possibility was never an issue in Belgium. Once the beneficiary receives the stock options, they fall in his private estate and any capital gains on the sale of the options or on the sale of the shares are tax-exempt as a matter of principle.

In 1999 the Government opted to take the grant of the stock options as the taxable event for their taxation (taxable event nr 1). The income tax is calculated on the value of the stock options and a favourable method was introduced to calculate the value of the options, in particular if the beneficiary agrees to keep the stock options for at least three years. The tax is due on a percentage of the value of the shares and for most ESOPs that is 7.5 per cent. There is no further tax when the employee exercises his option (taxable event nr 2) an when the employee exercises his option (taxable event nr 3), he can realise a capital gain that is tax exempt. Equally important is that no social security is due.

The only snag was that the employee has to pay tax in advance calculated on the value of the current price of the stock at a marginal rate of about 53 per cent, while he does not know yet whether he will make a profit.

The ESOP tax regime before 1999

Before 1999, the taxable event was the exercise of the option, or at least that was the position of the tax authorities.

In fact, the legislation that was introduced in 1984 did not even introduce a tax on stock options. To the contrary, it granted a tax exemption for the fringe benefit which an employee received from a qualifying stock option scheme.

This was a mistake, as there was no legislation to tax the benefit from a stock option scheme in the first place. This meant that many companies set up stock option schemes that did not

qualify, allowing their employees to receive tax-exempt stock options.

This was not seen favourably by the tax authorities, who defended the position that the stock options were liable to tax anyway. They issued tax assessments for the difference between the exercise price of the options and the market value of the shares at the time of exercise.

However, at the time the new stock option tax regime was introduced in 1999, the *Conseil d'Etat* had commented that taxing stock options at the time of their grant was merely an application of the general legal principles.

It was not until 2003 that the situation became clearer. On 16 January 2003, the *Cour de Cassation* confirmed that the taxable event was not the exercise but the grant of the option. The court also confirmed that the capital gain realized when the option is exercised is not compensation for work, but the result of the fluctuation of shares held in a private capacity, and thus, are not subject to income tax. In other words, once the beneficiary receives the stock options, they become his private property, and they cannot be taxed as earnings anymore. The *Cour de Cassation* confirmed that position in its decision of 7 November 2003.

The tax authorities did not give up and they tried to vary this case law in situations where stock options are granted conditionally. The Antwerp Court of Appeal of 19 February 2002 followed their arguments in a case where Monsanto had granted stock options under the following conditions :

- A maximum of one third could be exercised after one year;
- A maximum of another third could be exercised after two years;
- The rest could be exercised after three years;
- In any event, the options become void if the employment contract was terminated for cause;
- Moreover, the stock options were personal and conditional stock options which are not transferable.

The Court of Appeal decided that the stock options were "continuously precarious", which meant that they were not definitely granted until they are exercised, and it is only at that moment in time that they are transferred to his private estate and become liable to tax.

On 4 February 2005, the Belgian Supreme Court confirmed this decision of the Court of Appeal.

The new decision of the Supreme Court confirms its 2003 decisions: in principle, the taxable event is still the grant of the option. However, the Court states, it is not contradictory for the court of appeal to decide on the one hand that the taxable event is the grant of the stock option, and on the other hand that the taxable event is postponed if the possibility to exercise the option depends on an uncertain event in the future.

This is not the definitive decision on the pre 1999 stock options

It is noteworthy that it is not the responsibility of the Cour de Cassation to examine the specific

elements of the case. The court only checks whether the court of appeal has not made a mistake in applying the law. In this case, the Supreme Court limited its decision to stating that the decision of the Court of Appeal was not contradictory.

It was not clear from the previous decisions of the *Cour de Cassation*, whether the options in those cases were conditional or not; one can only presume that they had been. The question had not been submitted to the court in that form.

This decision will certainly not end all litigation. While the tax authorities will rely heavily on this decision, the taxpayer can continue to rely on the general principles. At the time the 1999 stock option tax regime was introduced, Parliament clearly stated that the existence of any conditions precedent or subsequent did not change the taxable event that is now always the grant of the stock options. This was, indeed, a variation of the general principles.

It is indeed generally accepted that the taxable event for a fringe benefit granted subject to a condition precedent is the moment that condition is met. *E.g.* if the fringe benefit will be received if the employee is still with the employer a year later, the fringe benefit will only be taxable at that moment in time.

On the other hand, there is case law that confirms that if a fringe benefit is granted subject to a condition subsequent, it is taxable immediately. The condition subsequent can, however, cancel the benefit retroactively, but the benefit has been granted immediately and was taxable immediately.

While they were waiting for this decision, the tax authorities had stalled a large number of procedures on the tax regime of pre 1999 stock options. These litigations can now be continued, but one will have to examine on a case-by-case basis when the stock options became definitively vested.

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