

Features

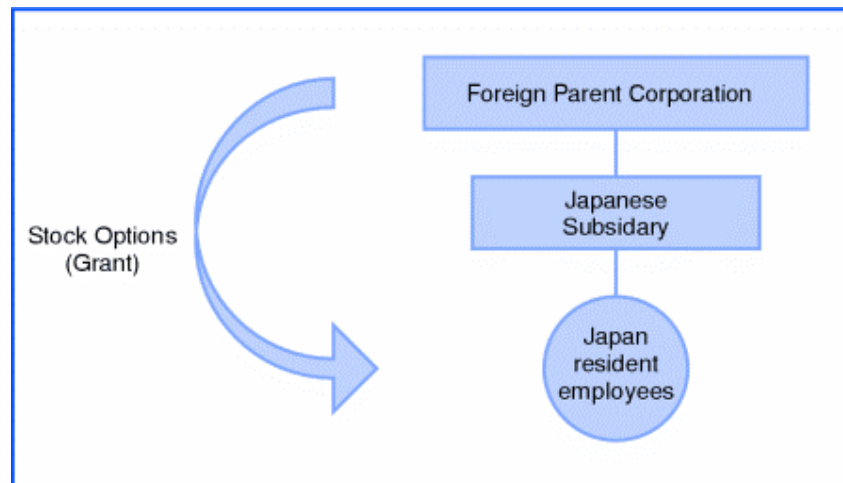
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How Japan taxes stock options

A new case has changed how employees of Japanese subsidiaries of foreign companies are taxed on their stock options. Ryuichi Tajima, Doug Rosser, Jonathan Stuart-Smith and Jonathan Golub of Deloitte Touche Tohmatsu, Tokyo explain why corporates need to review their plans

On November 26 2002 the Tokyo District Court considered whether the profit from the exercise of stock options (that is, the difference between the fair market value of the stock at the time of exercise and the exercise price, referred to herein as 'exercise profit') granted to an employee of a Japanese subsidiary by its overseas parent company should be classified as employment income or as occasional income. The court ultimately ruled against the National Tax Administration (NTA) in deciding that the exercise profit should be taxed as occasional income. This was favourable to the taxpayer since, as occasional income, only 50% of the exercise profit is taxed, after an annual deduction of ¥500,000 (\$4,200). The ruling has significant implications for the Japanese income tax filing positions taken by Japan resident taxpayers who find themselves in the situation illustrated in Diagram 1.

Diagram 1: Structuring stock options



The case

The plaintiff was a Japanese employee of a Japanese subsidiary of a US parent company, whose compensation included, in part, an equity incentive plan with an option to purchase stock of the US parent. When the plaintiff exercised his option, he reported the exercise profit as occasional income. The NTA subsequently audited his return and decided the plaintiff should have declared the exercise profit as employment income, resulting in additional taxes.

The taxpayer appealed the case to the district court. The basis of the court's decision was that income realized from the exercise of the stock option was the result of an independent investment decision made by the employee; the income was of an "accidental or temporary nature" and was difficult to attribute to the employment relationship. Accordingly, the court held that the exercise profit should be taxed as occasional income rather than employment income.

The court also commented on the taxation of the grant of an option, noting that, in principle, the grant could be taxable as employment income, since it has a value and is attributable to an employee's services. The judge indicated that in practice the grant is not taxable because of the difficulties of valuing a restricted option at the time of grant.

How employment income and occasional income are taxed

The court's decision is significant because it addresses a gap in the Japanese current tax code with respect to foreign corporations that issue stock to Japanese resident taxpayers. There is no specific provision under current Japanese income tax law that addresses the income categorization of the gain on stock options in this situation.

In practice, until the NTA issued revised guidance (*Basic Circular on Stock Options*) in 1996, the NTA accepted that the exercise profit could be treated as occasional income, except for cases where options were awarded to directors or employees of the stock-issuing company as compensation. After issuing the basic circular, the NTA has taken the position that the exercise profit should be treated as employment income.

The NTA further amended the relevant basic circular in 2001 to characterize exercise profits on options issued by foreign corporations as employment income. With the bull markets of the late 1990s, residents of Japan have often realized significant profits through the exercise of stock option rights granted over the stock of foreign corporations. Some taxpayers reported the gain as occasional income on their tax returns, which were challenged by the NTA to reclassify the benefit as employment income. Appeals against these amendments have been made and there are 50 separate cases before the courts.

Employment income is taxed at progressive rates of up to 50%, including local taxes. There is an employment deduction of 5% to 40% of the income, depending on the level of income. If gross employment income exceeds ¥10 million (\$84,800), the deduction is limited to 5% of the gross income plus ¥1.7 million.

If the exercise profit is taxed as occasional income, for a permanent resident of Japan (that is, one who intends to reside permanently in Japan or has resided there for more than five years), only 50% of the gain is subject to tax after deducting an annual statutory exemption of ¥500,000 (\$4,200). As a result, the maximum tax rate is 25%, including local inhabitant's tax.

The Japanese tax may be further reduced through the foreign tax credit provisions if a foreign tax is also payable on the gain.

A non-permanent resident (that is, one who intends to have a domicile in Japan for one year or more but whose period of residence does not exceed five years) and a non-resident individual are taxed only on their Japanese-source income. If the exercise profit is Japanese-source occasional income, approximately 50% of the exercise profit is taxable at graduated tax rates. If the exercise profit is non-Japanese source, the full amount is exempt from tax.

The territorial sourcing of income is important because:

- non-residents and non-permanent residents are taxed only on their Japanese-source income; and
- permanent residents are eligible for foreign tax credit relief for foreign taxes paid on non-Japanese-source income.

When income is regarded as employment income, non-permanent residents and non-residents are taxed on Japan-source employment income calculated by reference to the period of time spent performing services in Japan. The apportionment basis is not defined but is generally determined

based on the number of days in Japan during the period such employment income is earned. This time apportionment method appears to be tacitly accepted by the NTA.

The recent court case did not address the issue of territorial sourcing of exercise profits because the plaintiff was a Japanese national resident in Japan and no foreign taxes were payable on the stock option gain. There are no official pronouncements or other guidelines available to assist in determining the sourcing of the stock option gain. A time apportionment basis does not seem appropriate for determining the territorial source of occasional income. The income should be considered to be wholly Japanese-sourced or wholly non-Japanese sourced.

Factors to be considered in determining the territorial source include:

- the residence of the corporation issuing the shares;
- the residence of the individual on the exercise date;
- the residence of the individual on the grant date;
- the physical location of the share transfer and the share transfer agent; and
- the location of the employer deducting the cost for corporate tax purposes.

Table 1 summarizes the differences in the tax treatment of employment and occasional income.

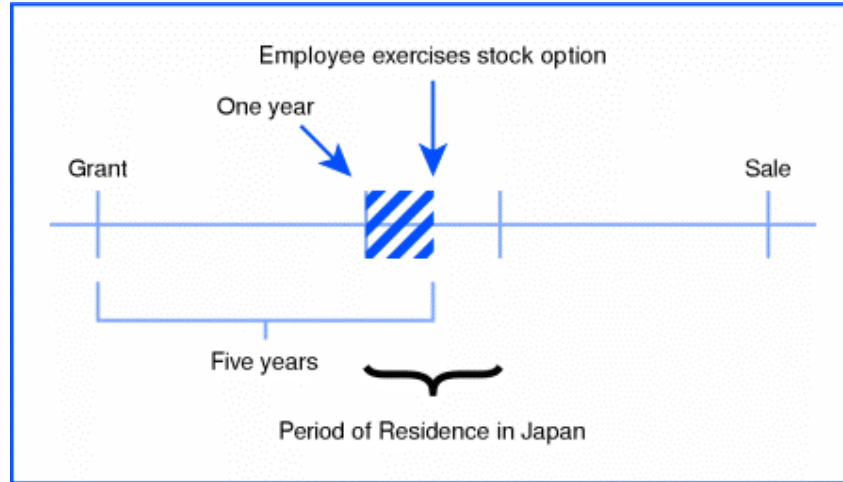
	Occasional income		Employment income	
	Japan source	Non-Japan source	Japan source	Non-Japan source
Permanent resident				
Sourcing	Geographical	Geographical	Time basis	Time basis
Taxable	Yes	Yes	Yes	Yes
Foreign tax credit	No	Yes	No	Yes
Income subject to tax	50%	50%	100%	100%
Deduction	·500.000	·500.000	5% (*)	5% (*)
Tax Rate	Graduated	Graduated	Graduated	Graduated
Non-permanent resident				
Sourcing	Geographical	Geographical	Time basis	Time basis
Taxable	Yes	No	Yes	No
Income subject to tax	50%	No	100%	No
Foreign tax credit	No	N/A	No	N/A
Deduction	·500.000	N/A	5% (*)	N/A
Tax Rate	Graduated	N/A	Graduated	N/A
Non-resident				
Sourcing	Geographical	Geographical	Time basis	Time basis
Taxable	Yes	No	Yes	No
Income subject to tax	50%	No	100%	No
Foreign tax credit	No	N/A	No	N/A
Deduction	· 500.000	N/A	None	N/A
Tax Rate	Graduated	N/A	20%	N/A

(*) Employment deduction of 5%-40% depending on income level. Where gross employment income

What it means for taxpayers

The timeline in Diagram 2 portrays the typical employee who holds stock options and resides in Japan for a period of time and will serve as the basis for illustrating the interplay between the timing, residence status and income sourcing issues comprising the taxation of exercise profit.

Diagram 2: Employee stock option timeline



Under the current system, the employee would be taxable on the Japan-source portion of the exercise profit as employment income. Thus, the amount taxable in Japan as employment income on exercise would be $100 \times 1/5 = 20$, where 100 equals the fair market value of the shares minus the strike price and 1/5 is the residence period in Japan until exercise over the total holding period (in practice, this fraction would be expressed in days, not years). As employment income, graduated rates of tax would apply to the "20" in the equation above.

Applying the ruling of the case, there would be more favourable taxation of the Japan-source portion in that a special deduction of ¥500,000 may be taken on Japan-source occasional income and tax would be levied at graduated rates on half of the amount remaining after the deduction. If the income was non-Japan source, the exercise profit would be exempt from Japanese tax. However, if the income were Japan source, the whole amount (100 in the above example) would be taxable, resulting in taxable occasional income of 50. The "50" would be subject to graduated rates of tax. The time basis apportionment would not be applicable to the income.

In this case, treatment as occasional income would result in a higher Japanese tax liability than if the income was classified as employment income. Thus, occasional income treatment may not necessarily be more favourable for expatriates on secondment to Japan for five years or less.

Filing options for 2002 and refund claims

The District Court judgment determined that the exercise profit recognized by a permanent resident from exercising a stock option on foreign stock should be categorized as occasional income. However, the NTA has appealed to a higher court and the final determination of the issue remains unclear. No final determination will be reached on the classification of exercise profits until either new legislation is introduced to classify the gain as employment income or a decision is reached by higher courts.

Taxpayers should be aware that the Japanese judicial process is weighted in the government's favour in tax cases. For the four-year period from 1997 to 2000, there were 1,028 tax cases filed at the District Court level. Excluding the cases that were dropped or dismissed, the NTA enjoyed an 87% rate of success in the lower courts. Of the 401 cases that were appealed to the higher court, that success rate rose to 90% on average. These are conservative numbers considering that they do not take into account the handful of cases that were decided partially in the NTA's favour. This should be kept in mind when choosing the filing position to take for 2002 and beyond.

Taxpayers have a number of options for filing their Japanese income tax returns for the year ended December 31 2002, which are due by March 17 2003. They can file the annual tax return and report the stock option gain as:

- occasional income;
- employment income and immediately file a claim for refund based on occasional income; or
- employment income and review issues once the appeal is final.

The cost/benefit analysis of each option is summarized in Table 2.

Table 2: Cost/benefit analysis

	Permanent resident	Non-permanent resident	Non-resident
Occasional	Tax rate reduced to 25% Risk of penalty & interest	Tax rate zero or 25% Risk of penalty & interest	Tax rate zero or to 18.5% Risk of penalty & interest
Employment	Tax rate to 47.5%	Tax rate to 47.5%	Tax rate to 20%
Employment with amendment	Tax rate to 47.5% Protects statutory right to refund Additional filing costs Avoids penalty & interest	Tax rate to 47.5% (graduated rates) Protects statutory right to refund Additional filing costs Avoids penalty & interest	Tax rate 20% Protects statutory right to refund Additional filing costs Avoids penalty & interest

If a taxpayer chooses to file a return on the basis that the exercise profit is categorized as occasional income and the courts determine the correct treatment is employment income, interest and penalties will be assessed. A 10% penalty (in some instances 15%) of the additional tax will be levied. An interest penalty will also be assessed on the unpaid amount (under current law, the rate is 4.1% but it is not assessed beyond one year).

A statutory limitation restricts the reassessment period to three years, or five years (seven years for fraud) where there has been no original assessment to tax made either via a tax return or payroll withholding. The period runs from the original filing due date.

If a taxpayer chooses to file a return on the basis that the exercise profit is categorized as employment income and the courts determine the correct treatment is occasional income, a request for refund may be filed. A request for refund must be made within one year of the original filing date of the return. Beyond the one-year limit, the individual can attempt to request a refund by use of a *tangansho* (an unofficial request for relief). However, in this case, the taxpayer has no automatic right to a refund. Approval is at the discretion of the NTA and the taxpayer has no legal remedies available should the request be denied.

As the NTA's stated position is that the exercise profit is employment income, it is expected that the NTA will reject any request for amendment. A request for reinvestigation must then be lodged with the tax tribunal. It may be possible to make an arrangement with the NTA or the tax tribunal to hold the refund request in abeyance until the higher court renders a decision in the current stock option case.

Regarding earlier years, taxpayers may request a refund for the year ended December 31 2001. This request should be filed within one year of the original filing due date, of March 15 2002. For years before 2001, taxpayers can attempt to request a refund by use of a *tangansho*. The statute of limitations of five years would apply to such requests.

Corporate tax

If the overseas parent incurs stock option costs and recharges the costs to the Japanese subsidiary, under current NTA practice the amount should be deductible by the Japanese subsidiary as a cost of employment. If the exercise profit is ultimately determined to be occasional income, there is a possibility that the recharge may be considered to be a non-deductible capital item.

Urgent review

Companies should review their stock plans to assess the applicability of the above case. The review should be undertaken as a matter of urgency given that the filing deadline for Japanese income tax returns for 2002 is March 17 2003 and the refund request period for income earned in 2001 will expire on that date.

The actual tax rate for occasional income is substantially less than the rate applied to employment income. However, because of the different sourcing rules for employment income and occasional income, the amount of the exercise profit subject to tax may be higher if categorized as Japanese-source occasional income. Therefore, the facts of each case should be reviewed to determine the filing position.

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