

**Tax reform regarding the Directors' remuneration and stock option fee**

The amendments to the Commercial Code in 2002 enabled corporations to introduce more flexible compensation scheme for directors, i.e., unfixed remuneration (performance based compensation) and non monetary compensation. These amendments were intended to strengthen the corporate competitiveness of Japanese corporations in the world market and enhance the corporate governance capability. Under the previous tax law (i.e., before 2006 tax reform), performance based compensation remuneration paid to directors was not allowed to deduct for the corporate tax purposes and this tax treatment was considered to decrease incentives for corporations to introduce the new compensation scheme for directors pursuant to the amended Commercial Code. The 2006 tax reform which relaxed requirements for a corporate deduction in relation to the directors remuneration (including stock option fees) is expected to increase number of corporation to introduce new compensation scheme for directors.

**I Background for 2006 tax reform in relation to the directors remuneration and stock option fee**

The 2006 tax reform in relation to the directors' remuneration includes (1) amendments to the requirements for tax deduction, (2) a new legislation for a corporate deduction of the stock option expense, and (3) an expansion of the qualified person for the preferred tax treatment of the stock option income.

**Overview of the 2006 tax reform in relation to the directors' remuneration**

<b>Tax treatment</b>	<b>Before the reform</b>	<b>After the reform</b>	<b>Applicability</b>
Scope of Directors	Officers, auditors, Shikko Yaku and any other who are substantially engaged in the management	KAIKEI-SANYO is added	Applicable to the fiscal years started on or after April 1, 2006
Deductibility of directors remuneration	Remuneration paid to directors on an irregular basis (i.e. in a manner other than equal monthly instalments) or remuneration that was determined in proportion to the company's earnings was treated as a non-deductible directors' bonus	Three types of deductible remuneration.  Fixed monthly payments.  Fixed payments in accordance with an advance notice to the tax office.  Performance bonuses paid in proportion to the company's earnings to directors who engage in the operation of the company's business.	Applicable to the fiscal years started on or after April 1, 2006
Limitation of deduction of directors remuneration applicable to family-owned corporation	N/A	Remuneration paid to directors and their related persons of the family-owned corporation is subject to the deduction limitation for the amount equivalent to the individual salary income deduction	Applicable to the fiscal years started on or after April 1, 2006
Deduction of stock option expense	N/A	Legislation to allow a corporate tax deduction for expenses relating to stock options	Applicable to the stock option granted pursuant to the provision in the new corporation law
Scope of tax qualified stock option	Directors, employees, and their successors	Executive officer (Shikko-yaku) is added	Applicable to the stock option granted pursuant to the provision in the new corporation law

Among the reform, a corporate tax deduction for expenses relating to stock options is legislated in correspondence to the new accounting guidelines for of the stock option expenses that is applicable to the stock option granted pursuant to the new corporation law.

The amendments to the requirements for tax deduction include (1) relaxation of requirements for tax deduction, and (2) limitation of deduction of directors' remuneration applicable to family-owned corporation. The former amendment is based on the underlying idea in the new corporation law which does no longer differentiate directors' base compensation from directors' bonus, i.e., both are compensation for directors services. Under the old Commercial Code, it was common understanding that the directors' base compensation is service compensation while directors' bonus payment is made out of the profit appropriation, and accordingly, the bonus payment was not treated tax deductible remuneration. The latter amendment was legislated to cope with the incorporation of the self-employed business for the purpose of tax saving.

## **II Relaxation to the requirements for tax deduction of directors' remuneration**

### **1. Fixed monthly payments**

This type of payment is deductible without any advance notice to the tax office or disclosure provided the relevant legal procedures have been followed (i.e. approval at the shareholders meeting or within the maximum amount specified in the company's by-laws). However, it should be noted that if the monthly amount is increased or decreased by way of a resolution at a shareholders meeting or compensation committee, such revision should be made within 3 months from the beginning of the fiscal year.

If a revision is made after 3 months from the beginning of the fiscal year to increase monthly payments, in principle, the portion exceeding the equal monthly installments will not be deductible.

If a revision is made after 3 months from the beginning of the fiscal year to decrease monthly payments, the company must have a specific reason, generally that due to worsening financial conditions, it has been decided to reduce monthly payments. Without such reason, in principle, the difference between the original monthly payment and reduced monthly payment made after the decrease will not be deductible.

## **2. Fixed payments in accordance with an advance notice to the tax office**

A pre-determined bonus is deductible provided the company has filed an advance notice with the tax office by the earlier of (i) 3 months from the beginning of the accounting fiscal year, or (ii) the day immediately before the relevant director commences the provision of his/her services. The notice must be filed annually for each director in respect of which a fixed bonus is expected to be paid. If the actual payment is different from the amount specified in the advance notice, the company cannot claim a deduction for the payment.

## **3. Performance bonuses paid in proportion to the company's earnings to directors who engage in the operation of the company's business**

A deduction for this type of payment can only be claimed by a company which is subject to an external audit pursuant to the Japanese Securities Exchange Act. A bonus that is determined in proportion to the company's earnings is deductible provided the following conditions are satisfied:

1. The remuneration is paid to directors who engage in the operation of the company's business and the company (excluding family companies or group subsidiary companies).
2. The remuneration formula is decided at a shareholders' meeting, compensation committee, audit committee or any similar organization within 3 months from the beginning of the fiscal year.
3. The remuneration formula and the definition of profit to which the formula is applied (by class of directors) is disclosed in the Japanese 10-K (a report similar to that filed by listed companies in other countries disclosing information relating to financial position and corporate activities).
4. The remuneration to be paid to each operating director (with prescribed ceiling) is calculated using the same formula.
5. The remuneration is paid or expected to be paid within 1 month after the profit of the company is finalized (ex. the income statement is approved at the shareholders' meeting (in the example below, March 1, 2008)).
6. The amount of remuneration is recognized as an expense in the company's income statement.

### **III Limitation of deduction of directors' remuneration applicable to family-owned corporation**

Under the new corporation law, a corporation is no longer required to have minimum amount of capital for incorporation. As a result, it is much easier for self-employed individuals to establish corporation for the purpose of tax saving. Suppose that a corporation pays remuneration to its directors (who also owner of the corporation) that satisfies requirements for a corporate deduction, some portion of the directors' individual income is excluded from taxable income (i.e., a salary income deduction). Without incorporation, director(s) will report his/her (their) earnings from the business as business income per the individual tax return.

From the individual income tax perspective, salary income is treated more favorable than business income because of the income deduction. As a result, there has been a concern that self-employed individuals would increasingly incorporate for his or her business to minimize individual tax burden.

The new legislation to disallow a deduction of certain amount of directors' remuneration was introduced as a counter-measure for such incorporation.

This new rule is applicable to the family-owned corporation which is incorporated under the New Corporation Law, as well as the corporations existing before the enactment of the New Corporation Law. However, the rule is not applicable to the corporation of which (1) the average income in the past three years does not exceed 8 million yen or (2) the average income in the past three years does not exceed 30 million yen and the salary expense for the operating directors is 50% or less of the income.

**Overview of the tax rules**

Corporation subject to the rule	Family-owned corporation satisfying the following requirements as of the year-end (1) 90% or more of the equity in the corporation is owned by the chief operating director and his/her related person(s), and (2) The total number of both chief operating director and his/her related person(s) is more than half of the total number of directors
Directors' remuneration subject to the rule	A portion of directors' remuneration equal to the amount of salary income deduction claimed for the individual income tax purposes by the recipient of the remuneration from the corporation
Exception to the application of the rule	The rule is not applicable for the year if (1) the average income in the past three years does not exceed 8 million yen, or (2) the average income in the past three years does not exceed 30 million yen and the salary expense for the operating directors is 50% or less of the income

**IV Legislation to allow a corporate tax deduction for expenses relating to stock options**

The new accounting guidelines on stock options apply to issuing companies of stock options that will be granted under the New Corporation Law. According to the guidelines, the fair value of the stock option should be recognized as an accounting loss for the issuing company from the date of granting to being vested. Under the 2006 tax reform, the issuing company is able to deduct such accounting expenses in the year the option is exercised to the extent that such compensation income that is realized upon exercise is subject to individual income tax (i.e., the stock option income is not part of a tax qualified stock option plan) as either one of salary income, retirement income, business income or miscellaneous income. Since the fair value of the stock option is not necessarily the same with the stock option income upon the exercise, the amount of deduction claimed by the corporation may be different from the individual income.

**Accounting and tax treatment of the stock option expenses**

	Accounting treatment	Corporate tax treatment		Individual taxation
		Tax non-qualified SOP	Tax qualified SOP	
Grant	Deduction of the fair value of stock option	Add back	Add back	
Vested				
Exercise	Convert into capital	Deduction as a tax adjustment	Deduction as a tax adjustment	Income taxation (salary income, business income, retirement income, miscellaneous income)
Expired	Gain from expired stock option	Deduction as a tax adjustment	Deduction as a tax adjustment	
Share transfer				Capital gain taxation

**Overview of the tax rules**

Requirement	Detail condition
Eligible stock subscription right	The stock option with certain restriction <ul style="list-style-type: none"> <li>• Stock option granted to the individual as consideration for the service provided to the corporation</li> <li>• Stock option taken over as a consequence of the corporate reorganization by the company from other company which grants stock option</li> </ul>
Corporation which is able to claim a deduction	Issuing company of the stock option
Timing when a deduction is claimed.	When the optionee is subject to the individual income taxation (salary income, business income, retirement income or miscellaneous income)
Any document form attached to the tax return in order to claim a deduction	Detail schedule is attached to the T/R (the schedule describes the issue price, number of option issued, number of option exercised and etc.)

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