



*Financial Services Tax Group*

# *News Letter*

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## **Judgment of the Tokyo High Court regarding classification of stock option benefit**

On February 19, 2004, the Tokyo High Court (Civil Case Division 8) held that the economic benefit from exercising the stock options granted by the parent company of an employer should be classified as salary income. This decision was preceded by similar decisions of the Yokohama District Court on January 21, 2004 and the Tokyo District Court (Civil Case Division 38) on January 31, 2004. It is reported that the defendant, individual taxpayer, will appeal to the Supreme Court.

The judgment of the Tokyo High Court was made on appeal from a decision in the Tokyo District Court in August 2003 where the profit derived from exercising stock options was held to be occasional income<sup>1</sup>. The National Tax Authority ('NTA') appealed this decision to the Tokyo High Court who overturned the decision and ruled in favor of the NTA that stock options were provided as remuneration for employment services and therefore classified as salary income rather than occasional income. A summary of the judgment and its reasoning is provided below:

### **I. Principle idea of salary income**

In order to classify the benefit derived from exercising stock options as occasional income, it is a prerequisite that the benefit is not treated as salary income. According to a decision of the Supreme Court in 1981, salary income is in principal

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<sup>1</sup> The tax base of occasional income is half of the amount after deduction of JPY500,000 per year, whereas the tax base of salary income is the amount after deduction of 5% to 40% of the gross salary revenue (5% of the revenue in excess of JPY10,000,000).

defined as remuneration for services provided under the command and control of the employer based on an employment contract or a similar relationship. Accordingly, classification of income as salary income should be determined after significant consideration whether the payment is regarded as remuneration for the continuous or recurring rendering of labor or services and acceptance of a sort of spatial or time binding of the employee in that relationship.

## II. Recognition of benefit derived from exercising of stock options and uncertainty of the amount of benefit

The benefit derived from exercising stock options is calculated as the difference between the market price of the parent company stock at the date of exercise and the exercise price. Accordingly realization of the benefit and the amount of the benefit depends on the movement of the stock value of the parent company after the grant of the stock option up to the time of the exercise as well as the taxpayer's own decision as to timing of exercise. Notwithstanding the above, stock options were recognized as remuneration for the provision of labor of the employee for the following reasons:

### ➤ Recognition of salary payment

When the option holder exercises the option, the parent company is obliged to provide to the option holder the company stock at the price designated in advance. At this time, the economic benefit equivalent to the market price of the parent company stock in excess of the exercise price is transferred to the option holder. The transfer of the benefit is attributable to an agreement between the taxpayer and the parent company, by which the stock option contract is concluded. The legal relationship of the exercise of the stock option is the same where both the company and the employee enter into a contract for the company to pay salaries by means of delivering its stock at a price below the market value in exchange for the employee's provision of labor.

### ➤ Remuneration of labor

The purpose of the provision of stock options is to motivate the employee's continuous and diligent attendance from the time of the option grant or even before

to the time of the option exercise. Thus the stock options are inseparably related to the provision of the labor.

Furthermore, the following conditions were attached to the stock option at stake: the stock option was provided to employees of the employer's group company only; the provision of service for a certain period was required prior to the exercise of the option; there were restrictions on the exercise period and the exercise price; the transfer of the option was prohibited; and termination of the employment relationship nullified the stock option or restricted the exercise period. The essential conditions of exercising stock options granted by the parent company and gaining the benefit thereby were inextricably linked to the provision of labor to the employer.

III. Remote correlation between quantity and quality of labor rendered and the amount of the benefit provided

The amount of salary is not always determined by the quality and quantity of the labor provided by the employee. There are cases of company-performance-oriented salary, where the salary is determined by external factors, such as the company performance, forecast of economic climate, which are only remotely correlated to the quality and quantity of the labor actually provided. Those instances where there is a remote correlation between the quantity and quality of rendered labor and the amount of the benefit are not sufficient to negate classifying the realized benefit as salary income.

IV. Tax implications of stock options granted by the employer's parent company

1. Difference between the entity rendering command and control and the option provider

Although the option holder has rendered labor under the command and control of the employer, the stock option is provided by the parent company. There is an argument that as it is a different entity that renders the command and control, to that which provides the options, it therefore cannot be characterized as salary income as remuneration for the provision of labor. According to definitions of salary income in the Income Tax Law, however, there seems to be no tax provision

designed to require that the identity of the entity rendering the command and control be the same as the option provider.

The Income Tax Law takes tax-paying capacity into consideration by classifying the income in accordance with its type and character. When an employee is provided with a benefit as remuneration for the provision of labor, it is difficult to conclude that the tax-paying capacity or the character of the income varies depending on whether or not the option provider is the entity which renders command and control. It would be unreasonable to argue that classification of income differs depending on who provides the economic benefit thereby resulting in a significant difference in tax liability.

## 2. Indirect employment relationship with the option provider

Interest in a subsidiary constitutes a part of a parent company's assets and improvement of its subsidiary's business performance increases the value of the parent company's asset. It is reasonable for a parent company to grant stock options to employees of its subsidiary as remuneration for the provision of labor. Therefore, the stock option at stake was recognized as remuneration for the provision of labor to the subsidiary.

According to Article 29-2 of the Special Tax Measure Law, a certain type of stock option designated by the Commercial Code is entitled to the deferral of taxation on the benefit derived from exercising the stock option by exempting the income tax at the time of the option exercise. Since this provision is placed in the articles regarding salary and retirement income, it is reasonable to conclude that the benefit derived from exercising stock options designated by the Commercial Code should be treated as salary income. Since this provision also allows tax deferral to the stock options granted to the employee of a subsidiary (owned more than 50% by the option provider), the benefit derived from exercising the stock options granted to the subsidiary's employees should be treated as salary income regardless of the indirect employment relationship between the option provider and the option holder. The principles of taxation law applied to stock options designated by the Commercial Code should also be applied to stock options provided by a foreign parent company.

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