

Financial Services Tax News

Financial Services Tax Group

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Profit arising from the exercise of stock options is ruled to be salary income Final decision by the Supreme Court on January 25, 2005

Different decisions were issued by the Tokyo Local Court and the Tokyo High Court with respect to the Japanese tax treatment of profits arising from exercising stock options ("stock option exercise gain") that were granted to a representative director of a Japanese corporation which is a wholly owned subsidiary of a US corporation. On January 25, 2005, the third small court of the Supreme Court confirmed the decision that was issued by the Tokyo High Court by a unanimous vote of four (4) judges. Specifically, the judges concluded that the stock option exercise gain should be treated as salary income and therefore, rejected the final appeal by the taxpayer. This appears to have ended the argument as to whether the stock option exercise gain should be treated as salary income or occasional income for Japanese individual income tax purposes. Based on the Supreme Court's decision, in the future, such stock option exercise gains should be treated as salary income.

1. Accounting Standard for Stock Options (Draft) Market value of stock option rights at the time of grant would be reported as an expense?

On December 28, 2004, the Accounting Standards Board of Japan announced Proposal No. 3 of the Corporate Accounting Standard – "Accounting Standard for Stock Options (Draft)" (hereinafter referred to as "Proposal"), which will become effective for stock options granted in fiscal years commencing on or after April 1, 2006.

In the above Proposal, the market value of the option right* as of the date of grant should be reported as an expense and be amortized equally over the vesting period.

Although the stock option exercise profit under an employees' stock option plan is treated as salary income in accordance with above decision of the Supreme Court, the tax treatment for corporate tax purposes has not been clearly determined. As a result of the announcement of the Proposal, it is expected that discussions relating to clarifying the tax treatment of expenses recognized in connection with employee stock option plans for corporate tax purposes will begin.

2. Stock option with exercise price of 1 JPY

Generally, the stock option exercise price under an employees' stock option plan is determined based on the market value of the shares that are subject to the stock option as of the date of grant. In one case, a company wanted to introduce a stock option plan in which the exercise price would be 1 JPY and they asked the Regional Taxation Bureau in advance as to whether taxable income should be recognized at the time that the option is exercised. The Regional Taxation Bureau stated that the above tax treatment that taxable income should be recognized at the time the option is exercised is appropriate for such stock option plan and disclosed its reply and question in its web site.

3. Stock option as a retirement allowance plan

In another case, a company granted stock options to its directors at the time of the termination of the directors' retirement allowance plan. The tax authorities issued a reply that indicated that the stock option exercise profit in that particular case would be treated as retirement income. In the said stock option agreement, various conditions were provided including the following:

- (i) the exercise price is 1 JPY;
- (ii) the director has the right to exercise the options only once during the 10 day period from the date the director resigns as a director of the company;
- (iii) a forfeiture clause; and
- (iv) the number of allotted options is determined according to the title and service years of the director (i.e. grantee).

*This is the market value of the option right as of the date of grant, not the market value of the objective stocks (or a portion of the market value of the objective stocks in excess of the exercise price) as of the date of grant, the vesting date or the date of exercise.

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