



News Flash

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This article gives an update on the recent court rulings regarding the Japanese taxation of stock option income based on information available as of March 8, 2004.

We recommend that you consult with PricewaterhouseCoopers to confirm the finalized position, and do not take any action based solely on the contents of this News Flash.

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Stock Option Income Tax Litigation

Summary of the recent court rulings

In 2 rulings in February 2004, the Tokyo Upper Court reversed earlier judgments of the Tokyo District Court and held in favor of the National Tax Agency ("NTA"), to the effect that stock option income, where the stock options were issued to an individual in connection with their employment, and were over shares of a foreign company related to their employer (i.e., Japanese subsidiary), should be treated as Employment Income rather than Occasional Income. The Upper Court reached these judgments despite the taxpayers' counter-arguments that:

- (1) the quantum of stock option income resulting on exercise of the options was not directly linked to the value of the employment services provided by the taxpayers, and
- (2) the stock option income, the stock options themselves, and the underlying stock, were not received directly from the employer,

holding that the purpose of the stock option plan was clearly to remunerate the taxpayer for their employment services.

The judgments have since been appealed by the individual taxpayers to the Supreme Court. Until the Supreme Court has ruled on the matter, thereby providing definitive guidance as to the correct treatment to be adopted (which may take a couple of years), there will therefore remain some uncertainty as to the correct tax treatment of stock option income for individual income tax (i.e., income tax filing and amended tax return filing) purposes.

Our recommendations as regards filing of 2003 individual tax returns

For those who have stock option income in the 2003 tax year, in general we recommend that such income is reported as Employment Income, in order to avoid the penalty tax that may be assessed if the income is reported as Occasional Income in the tax return, and this approach is later held to be incorrect. It remains possible that the Supreme Court may ultimately rule in favor of treatment of stock option income as Occasional Income, in some or

all situations. If such a ruling occurs more than five years after the filing due date of a tax return in which stock option income was reported as Employment Income, it will in principle not be possible for the NTA to make a downward correction, and thus not be possible for taxpayers to claim a tax refund. In order to protect their position, we therefore recommend that taxpayers who report a material amount of stock option income as Employment Income in their tax return request the NTA for a downward correction¹ of the tax amount that was reported in the tax return. Since such a request for a downward correction should be made within one year from the tax return filing due date, taxpayers should make such a request by March 15, 2004 for the 2002 tax return, and by March 15, 2005 for the 2003 tax return.

We would expect the NTA to reject requests for downward correction, in which case it will then be necessary for the taxpayer to decide whether or not to file an objection to the NTA's decision (within 2 month of the NTA's decision) and seek further administrative remedies. While the cost involved up to this point should be relatively low, pursuing judicial remedies may not be cost-effective, unless a significant amount of tax is at stake. Taxpayers will thus need to take account of their specific facts and circumstances, and we would of course be happy to assist in this regard.

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¹ The marginal tax rates for Occasional Income are about half of those applied to Employment Income. A taxpayer who reported stock option income as Employment Income but wishes to dispute this classification with the NTA can request for a downward correction of the tax reported.