

International Assignment Services Alert

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PwC Japan Tax Newsletter

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Employee Reporting of Foreign Parent Company Equity Awards

In Brief

In recent weeks, a number of accounts regarding the underreporting of equity income by senior executives at foreign-based companies in Japan have been published in the Japanese press. In addition to potentially significant financial penalties assessed against the individuals, their employers or former employers also face potential damage to their reputations as upstanding corporate citizens in Japan. This newsletter will address the company's responsibilities in these situations, including how companies may take action to protect their reputations and any potential damage to their global brands.

If properly structured, equity-based compensation awards granted to either local national or expatriate employees working for a Japanese subsidiary or branch office of a foreign parent company should be taxable to the employee as "ordinary income" when the underlying promised shares are actually transferred to the employee. In the case of restricted stock units, for example, the stock transfer date will typically occur only upon full vesting of the stock award. For stock option rights, however, the underlying shares are transferred to employees upon exercise of the stock option right(s) and payment of the exercise price.

It has been the past practice of most foreign parent companies that grant equity-based compensation awards to Japan based employees not to withhold Japanese wage withholding taxes from the ordinary income amount realized by the employee upon transfer of the underlying stock. This "no withholding" approach has been generally followed where: (i) the decision to grant the employee equity award is made outside of Japan (ii) the management and administration of the equity award program is outside Japan and (iii) the transfer of the promised shares is made to an offshore account. If all of the above requirements are met (with the exception mentioned below), this approach has been accepted by the Japanese taxing authorities even where all or a portion of the compensation attributable to the equity award is ultimately recharged to the Japanese employer and deducted as a compensation expense for Japanese corporate income tax purposes.

If the Japan entity is a branch office of a foreign company and is transferring equity-based compensation to nonresident employees, the Japan branch office is required by law to withhold income taxes from the equity award.

Although the employee is ultimately responsible to report and pay taxes on any taxable equity income received, even if delivered offshore, the Japan employer is also expected to take certain steps towards achieving such tax reporting compliance. This PwC tax newsletter is intended as a reminder to companies of their responsibilities in this regard.

To ensure individual tax compliance, the Japanese taxing authorities expect that the employer has provided the following to the employee to encourage and assist with their personal income tax compliance:

1. timely and sufficient information reporting concerning the offshore equity income
2. a reminder of the employee's personal tax responsibility (i.e., tax return filing and tax payment)
3. advice to seek professional tax assistance and/or tax return preparation services, if needed

While the employer need not verify or enforce the employee's tax reporting of the offshore equity income, it should be able to demonstrate a proactive assistance towards such tax compliance. The consequences of not doing so may result in company reputational risk with the Tax Office. This then could lead to more scrutiny on corporate tax compliance matters, as well as damage to the reputation of the firm in the market.

Specific Actions a Company Can Take

Based on our experience in assisting many companies responding to the Japan tax authorities on this matter of company responsibility for employee tax reporting of offshore company equity income, we have provided (below) some specific actions a company may consider implementing.

(Not in any order of priority)

1. written internal communication in Japanese (and English if needed) to employees denoting their tax filing and tax payment responsibility (should be done annually)
2. seminars conducted (e.g., by professional tax advisors) for employees to discuss tax compliance steps
3. reference to the Japanese online tax compliance instructions and preparation of a tax compliance manual (in English, if needed) to assist the employees with tax return preparation and filings
4. professional tax return preparation assistance
5. request employees to provide written confirmation that their tax return including equity income was filed timely

Bottom Line

In summary, it may not be sufficient for a company to simply advise their employees of their tax filing requirement for the offshore equity income. Lately, we have found that the tax and regulatory authorities are questioning what clearly defined actions the company has taken (or will take) upon discovery of non-compliance by their employees. Essentially, the authorities seem to be confirming whether the culture of tax compliance permeates the company and is robust.

For more information, please consult your international assignment services representative or contact any of the following members listed below:

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