

RECHTSPRECHUNG / JURISPRUDENCE

Taxation of Stock Options Judgment of the Supreme Court, 25 January 2005

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Stock options were introduced in Japan in 1997 and were further liberalised in 2002. At present, more than one-third of the listed companies utilise this system to reward directors and employees. There have been divided views on the taxation of stock options. The problem primarily involves the stock options granted to Japanese executives of subsidiaries of foreign companies. The issue is whether these stock options should be regarded as a temporary income and enjoy a much lower tax rate, or as a salaried income which presupposes full taxation. The National Tax Agency treated stock options as a temporary income in the early days, but has changed its policy in the late 1990s and now categorises them as a salaried income. This change of policy led to a number of litigations.

At the district court level, the judgments were divided, while at the High Court level, the mainstream position was to categorise them as a salaried income.

In the present case, the *jōkoku* appellant is a representative director of a 100% subsidiary in Japan of a US company. He concluded a stock option agreement with the US parent company and later exercised the option. He made a profit of 40,594,875 yen and 155,228,062 yen in 1996 and 1997 respectively and declared it as a temporary income in his tax return. The National Tax Agency, which is the *jōkoku* appellee, rejected this and found it to be a salaried income. The *jōkoku* appellant contested this decision up to the Supreme Court.

The Supreme Court found the income to be a salaried income, since the parent company had provided a benefit to the *jōkoku* appellant by enabling him to acquire shares at a pre-arranged price.¹ The problem with this interpretation is that there is no direct employment or service contract between the US parent company and the *jōkoku* appellant, and therefore, it may be difficult to qualify the income as a salaried income. In this respect, the Supreme Court ruled that since the parent company had actual control of the Japanese subsidiary, the *jōkoku* appellant could be regarded to have been carrying out business as a representative director under the control of the US parent company. The economic benefit which the *jōkoku* appellant received through the stock option scheme

¹ For the Japanese text of the judgment, see <www.courts.go.jp>. See also Nikkei, January 26, 2005.

was a reward for the work he had done. Therefore, the economic benefit in the present case was a reward for the work based upon a labour contract or similar ground and should be regarded as a salaried income.

It should be added that the Japan Accounting Standards Board has recently adopted accounting criteria which require stock options to be categorised as a cost.