Japanese Tax Treatment of Stock Options for Shares of Foreign Parent Company

On June 2, 2011, the Tokyo Regional Taxation Bureau announced that it had filed charges against a JPMorgan Securities Japan Co., Ltd. (“JPMorgan Japan”) employee for failing to declare approximately JPY 140 million from the exercise of certain stock options for the shares of JPMorgan Japan’s parent company, JPMorgan Chase & Co. The media also reported that the Bureau investigated over a hundred other JPMorgan Japan employees and asserted that it discovered over JPY 1 billion of undeclared income.

According to the Act on Special Measures Concerning Taxation (the “Act”), if stock options meet certain requirements, they can be categorized as “tax-qualified” stock options, where the exercise of the option is not a taxable event, and tax is instead applied to any capital gain received by the shareholder when the shares are sold on the market. However, if the stock options do not meet such requirements and are categorized as “non tax-qualified” stock options, the exercise of the stock options becomes a taxable event, and the difference between the exercise price and the share’s market value would be taxed as “employment income” upon exercise even though the option shares had never been sold by the optionee.

Unfortunately, stock options involving a foreign parent company’s shares cannot qualify as “tax-qualified” stock options because the Act only provides for such qualification for the stock options of a Japanese company’s shares. Further, the exercise of the foreign parent company stock option would likely result in the Bureau applying tax at the “employment income” rate rather than the lower “temporary income” rate. Indeed, foreign companies doing business in Japan should be aware of these issues, obtain appropriate tax advice from their accountant or tax attorney, and properly inform their employees in Japan of the stock options’ potential tax treatment when granting stock options for shares of its foreign parent company.

1 On January 25, 2005, the Supreme Court of Japan ruled that regardless of the lack of a direct employment relationship between the foreign parent company and its Japanese subsidiary’s employee, the exercise of the foreign parent company’s stock options would be taxed at the “employment income” rate rather than the lower “temporary income” rate.