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GRANTS OF OVERSEAS PARENT COMPANY STOCK OPTIONS—A SWEET AND SOUR PERK

The issuance of stock options to attract and retain talent is a relatively recent development in Japan, but quickly has become a widespread form of incentive benefit. Despite its appeal, a local recipient of a stock option for the shares of a non-Japanese parent company may need to think twice before accepting such perk as exercising these options can leave the recipient with a hefty upfront tax bill. The possible reduction in the economic appeal of an overseas parent company stock option grant should be heeded not only by the stock option recipient residing in Japan, but the overseas parent granting such stock options also should carefully consider the full economic impact of these grants in order to ensure its perquisites package encourages the desired levels of director and employee motivation and retention.

Background

Employee stock ownership in an employer often fosters a feeling of being more "connected" to the business, and stock ownership can allow the employee to reap some of the financial benefits of a successful business. A stock option provides the recipient with the opportunity to buy a specified number of shares in the subject company for a certain number of years. The exercise price is typically equal to or higher than the underlying security's market price at the time the option is granted. The benefit is that the recipient can exercise the option when he or she wants within a set period of time. If the stock price of the subject company has gone up, then he or she can purchase the shares at the original grant price and then either sell the shares for a profit or hold onto the shares in the hope that the price of the stock will continue to rise.

Prior to June 1997, Japanese firms were effectively precluded by law from issuing stock options. In May 1997, Japan's Commercial Code was amended so that from June 1, 1997, firms could commence using option-based compensation. The popularity of stock options in Japan has gained momentum, as the "TSE-Listed Companies White Paper on Corporate Governance 2011" indicates that approximately 30% of the companies listed on Tokyo Stock Exchange have issued stock options, including the likes of Toyota, Hitachi, and Panasonic. To compete for talent, overseas companies operating in Japan may naturally feel compelled to offer similar stock ownership opportunities to attract qualified directors and employees. For those multinationals who operate in Japan through a wholly-owned or closely held company, issuing options covering the stock of the local subsidiary is not optimal, so the publicly traded shares of the overseas parent company are commonly used as the subject shares for the stock option grant.

While the offering of such stock options can be made without great difficulty under Japanese securities laws, the employer and stock option recipient should carefully consider the potentially debilitating tax consequences that the option recipient may face upon the exercise of these grants.

Japanese Securities Law Considerations

Absent the availability of an exemption, a company offering and granting stock options to persons located in Japan is required to deliver a prospectus to each offeree, file a registration statement with the local regulator covering the offering, and after the closing of the offering comply with the periodic disclosure and reporting requirements under Japanese securities laws. Needless to say, Japanese compliance costs could sky rocket for the overseas parent company as a result of the foregoing. All is not lost!

The typical Japan exemptions that apply to overseas parent company stock option offers and grants are the following:

- *Grants to persons at direct and indirect wholly-owned subsidiaries*. The offer and grant of a non-transferable (other than by inheritance) stock option by a non-Japanese parent company to directors and employees in Japan who serve at the parent's direct wholly-owned Japan subsidiary is exempt from the prospectus delivery and registration statement filing requirements under Japanese securities laws. Since 2011, the foregoing exemption also has been available for offers or grants by an overseas parent company to the directors or employees of a Japan wholly-owned subsidiary of the parent's direct wholly-owned Japan subsidiary. This exemption, however, does not extend to further indirectly wholly-owned Japan subsidiaries of the overseas parent company (*e.g.*, this exemption is not available to a third-tier Japan subsidiary of an overseas parent company).

- *Other grants*. A non-Japanese company can offer and grant stock options to persons located in Japan without complying with Japanese securities registration procedures if (i) the parent makes offers to less than 50 persons located in Japan during any six month period (note that unlike U.S. securities laws, Japanese securities laws generally examine the location of where the offer and sale is made rather than the residency of the recipient), or (ii) the "value" of all options (with "value" equaling the purchase price paid by the holder to receive the option (which is typically a *de minimis* amount, if any) plus the option exercise price, multiplied by the number of shares subject to the option) granted to persons located in Japan is less than ¥100 million during any 12 month period. Since there are no restrictions on the class of offerees (unlike the above), these exemptions are particularly useful if the Japan operations are not wholly-owned by the

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parent (*e.g.*, due to the inability to squeeze-out the minority shareholders) or involve lower tier Japan subsidiaries.

While the foregoing exemptions relieve the parent company from the obligation to deliver a prospectus to offerees and file a registration statement with the local regulator, the option-issuing parent company is still required to submit to the local regulator a securities notification report (*yukashoken tsuchisho*) if the aggregate value of the options granted in an offering to persons located in Japan is greater than ¥10 million (unless the option-issuing parent company is relying on the exemption that it has made offers to less than 50 persons located in Japan during any six month period, in which case, no securities notification report needs to be submitted). A securities notification report is a short-form document that does not require the regulator's consent or approval to commence or effect the stock option offering, and does not obligate the filer to comply with the periodic disclosure and reporting requirements under Japanese securities laws.

Counsel should be retained to guide an overseas parent company through the stock option offer and issuance process to confirm compliance with Japanese securities laws, as well as consider difficult questions that may arise, such as what constitutes an offer, when has an offer commenced and been completed (which is particularly helpful when evaluating whether a securities notification report is required because the ¥10 million threshold has been exceeded), who is an offeree (especially if stock options will be granted to an employee owned cooperative), and how best to navigate through Japanese securities fraud rules with respect to information provided to option recipients despite qualifying for a registration exemption.

Japanese Tax Considerations

Directors and employees of Japanese subsidiaries of overseas companies may face a hefty tax burden when exercising a stock option for the shares of a non-Japanese parent company.

According to the local media, on June 1, 2011, the Tokyo Regional Taxation Bureau filed a complaint against a former JPMorgan Securities Japan Co. executive alleging that he evaded approximately ¥50 million in taxes on profits he earned through stock transactions. According to the press, the complaint filed with the Tokyo District Public Prosecutor's Office indicated that the executive failed to declare approximately ¥140 million in profits from exercising options that entitled him to shares in the company's U.S. parent, JPMorgan Chase & Co. The media also reported that the tax bureau investigated approximately 100 other JPMorgan Securities Japan Co. employees over stock options for JPMorgan Chase and indicated that approximately ¥2 billion in taxable gain had not been declared on the exercise of these overseas parent company stock options.

The foregoing leads to two fundamental questions a stock option recipient should consider: (i) when does a tax obligation arise in connection with the exercise of a stock option and (ii) what tax rate is applied to any profit arising from a stock option exercise?

Tax obligation crystallized. Japan's Act on Special Measures Concerning Taxation states that if stock options meet certain requirements, then they can be categorized as "tax-qualified" stock options, and the exercise of the option is not a taxable event. Under such circumstances, Japanese tax is applied to any capital gain received by the option holder when the shares are subsequently sold on the market. Stock options involving a non-Japanese company's shares, however, cannot qualify as "tax-qualified" stock options because the Act on Special Measures Concerning Taxation only provides for such treatment for stock options involving the shares of a company organized under Japanese law. Accordingly, a recipient of a "non tax-qualified" stock option will face a tax obligation upon the exercise of the stock option, which will be before any income is actually received from the sale of the shares underlying the option grant (unless the option grant has been monetized by the holder).

Applicable tax rate. To add insult to injury, in light of a 2005 Japan Supreme Court ruling, upon the exercise of a non tax-qualified stock option, "employment income" is considered created (rather than "occasional income") equal to the difference between the exercise price and the subject share's market value at the time of exercise. For a Japan permanent resident who does not have any foreign tax credits to offset a corresponding Japanese tax obligation and was granted the stock option while residing in Japan, exercise profit taxed as "employment income" is taxed at progressive rates of up to 50%, including local taxes. Had the exercise profit been taxed as "occasional income", then only 50% of the gain would have been added to ordinary taxable income, after deducting an annual statutory exemption. As a result, the maximum tax rate for "occasional income" under such circumstances is often approximately 25%, including local taxes.

Tying the above together, a recipient of an option covering the shares of an overseas parent company would owe a Japanese tax obligation based on regular "employment income" rates for a paper gain generated upon exercise. If the stock option exercise is large, then this tax burden could place the option holder in significant financial difficulties and potentially lead to resentment by the option holder – not the outcome that the overseas parent company wanted the option holder to associate with the perquisite.

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Overseas companies doing business in Japan may wish to pay close attention to the above Japanese securities laws matters to avoid costly mistakes, and inform stock option recipients about Japanese income tax consequences of overseas parent company stock option grants to avoid possible economic panic upon exercise and potential negative publicity if local taxes are avoided. As Japan's compensation schemes become more diversified, we expect to see more exotic instruments offered to directors and employees to mitigate the effects of Japanese taxation taking an upfront bite out of employer benevolence.

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