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Japan Inbound Tax & Legal Newsletter

Recent reforms impacting deductions of foreign stock compensation granted to directors

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Overview

Compensation paid to a director is, in principle, not deductible for Japanese corporate tax purposes. However, there are exceptions for the following:

1. Fixed Compensation – compensation paid in equal installments at least monthly;
2. Pre-Notified Compensation – compensation for which the company notifies the tax authority in advance regarding the compensation to be paid to a director; or
3. Performance-Linked Compensation – compensation based on performance provided certain conditions are met. Generally, only publicly traded Japanese companies are eligible under this category.

Also, regardless of whether or not the compensation paid to a director falls under one of the above exceptions, if such compensation is considered as excessive, the excessive portion will be disallowed as a deduction.

Further, parent company stock compensation (e.g. stock options, restricted stock, etc.) granted to directors of a subsidiary was generally not eligible to qualify for one of the above exceptions. However, since the 2016 and 2017 tax reforms entered into effect, certain parent company stock compensation issued to directors of a Japanese subsidiary became eligible for deduction provided it can fall into one of the above mentioned exceptions.

Please note that the rules regarding the deductibility of stock compensation under Japanese corporate tax law discussed in this newsletter relate to stock compensation granted by a Japanese company. There are no specific tax laws addressing stock compensation granted by a foreign parent company. However, while there is some uncertainty, in practice and under the right circumstances, the rules for Japanese stock compensation may be applied to foreign stock compensation.

1. Tax reforms

(1) Qualifying restricted stock eligible for Pre-Notified Compensation under 2016 tax reform

Under the 2016 tax reform, restricted stock compensation granted by a parent company to a director of a 100% owned Japanese subsidiary qualified as Pre-Notified Compensation provided certain conditions (including that the compensation be for future services to be rendered by the director, restrictions are imposed on the transfer of such stock for a certain period, and certain disclosures are made on the subsidiaries corporate tax return) are satisfied. In addition, an advance notification would need to be timely filed, but such notification may be exempted under certain situations.

(2) Expanded scope of Pre-Notified Compensation under 2017 tax reform

Under the 2017 tax reform, parent stock compensation treated as Pre-Notified Compensation was expanded to include stock options with a fixed number of shares to be issued at a pre-determined time provided such options had a market price. Further, the ownership threshold of the parent company granting the stock compensation dropped such that parent stock compensation granted to a director of a more than 50% owned Japanese subsidiary became eligible for treatment as Pre-Notified Compensation. An example of stock compensation that may be classified as Pre-Notified Compensation is stock options that require a director to continue to be a director for a specified number of years before such options vest with the director and can be exercised. In addition, an advance notification would need to be timely filed, but such notification may be exempted under certain situations.

However, any stock compensation that that is granted based on the director's performance should not be classified as Pre-Notified Compensation (even if other conditions are satisfied), but instead, as Performance-Linked Compensation and eligible for a deduction only if the conditions associated with the Performance-Linked Compensation category are satisfied (i.e. submitting an annual report to the Japanese finance bureau with details of the compensation). In general, it is difficult for Japanese subsidiaries of foreign multinationals to satisfy this condition.

2. Key procedures to qualify as Pre-Notified Compensation

(1) Legal procedures

Generally, total director compensation (including stock compensation) should be approved during a shareholder's meeting of the Japanese subsidiary, however, once total compensation is approved, each individual director's compensation amount can be determined by a meeting of the directors. Please note that any director compensation in excess of what is approved at the shareholder's meeting is generally not deductible for Japanese corporate tax purposes.

Regarding foreign parent stock compensation, a recharge agreement should be established such that the Japanese subsidiary burdens the costs of the stock compensation granted by its parent company.

(2) Advance notification

Advance notification generally must be submitted to the tax office within one month from the date of a shareholder's meeting or director's meeting that resolves the director compensation (if directors start working before that date, the working start date) or 4 months from the beginning of fiscal year, whichever is earlier.

The advanced notification requires the following information to be included:

- name of directors to which stock compensation is granted,
- date of grant,
- name of issuing company,
- number of shares or stock options granted,
- fair market value of stock compensation etc.

Deloitte's View

While many types of stock compensation issued by a foreign parent company to directors of its Japanese subsidiary remain non-deductible (e.g. stock compensation based on performance), companies should not automatically assume that the stock compensation offered to their directors is non-deductible and they may want to reexamine their stock compensation program to determine whether it already meets the conditions to be treated as Pre-Notified Compensation or whether some amendments can be made to meet such conditions.

For example, it is not uncommon for a foreign multinational company to have a global compensation program designed to enhance the performance of, and retain, its directors worldwide by offering stock compensation. To the extent such program focuses more on the retention of the directors (i.e. grants certain stock compensation based purely on the condition that the director remain with the company for a number of years rather than based on the performance), the stock compensation granted under such program may be deductible with advanced notification.

Given that the advanced notification creates some additional compliance and requires disclosure of information regarding directors receiving the stock compensation, some companies may be hesitant to proceed with the advance notification. However, it should be noted that much of the information requested may be required to be reported by the company anyway under a separate tax law that requires companies to report to the tax authorities all vested foreign stock compensation provided to employees and directors.

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