

Recent Legislation in Japan

1. Provisions for Restricted Stock as Deductible Expenses

Professor Tetsuya WATANABE
(Research Staff, Faculty of Law)

1. Current Executive Compensation Provisions (limits to inclusion in the deductible expenses)

The remuneration that a corporation pays to an executive (referred to as “executive compensation” in the Corporation Tax Act) is an expense for that corporation, so inherently, this expense should be included in the deductible expenses for corporate tax purpose. However, as provided for by Article 34 (1) of the current Corporation Tax Act, as long as executive compensation does not fall under (i) regular same amount compensation, (ii) pre-determined compensation, or (iii) profit-linked compensation, in principle, it cannot be included in the deductible expenses (first hurdle). Further, even if it falls under any of the three categories mentioned above, if amount of the executive compensation is unreasonably high, the portion deemed high is not included in the deductible expenses (second hurdle). The reason for these hurdles, for its inclusion in the deductible expenses, is to prevent manipulation of income by the corporation.

2. Corporate Governance-based Argument to Introduce Restricted Stock and Non-Deductible Expenses

The number of companies in Japan that introduce incentive compensation for executives (managers) is set to increase, following the implementation of the Corporate Governance Code in June 2015.

Restricted stock is a type of incentive compensation that involves giving executives a certain number of shares with restrictions on their disposition (in place of cash compensation). By doing so, executives are expected to manage the company from the perspective of shareholders. The executive is encouraged to work diligently and if there were an increase in share prices, it would lead to an increase in his/her total compensation. To address concerns regarding the executive “selling off”

these shares at a profit with a rise in share price, a limitation is imposed to restrict the disposition of these shares.

However, since restricted stock does not fall under any of the three categories mentioned above, provided for in Article 34 (1) of the Corporation Tax Act, it cannot be, therefore, included in the deductible expenses. In this respect, the tax law could inhibit the development of healthy corporate governance. Actually, corporate law scholars and related practitioners have severely criticized the treatment of non-deductible expenses in the Corporation Tax Act.

3. The 2016 Tax Reform Proposal

Based on the above criticism, the 2016 Tax Reform Proposal which Liberal Democratic Party and Komeito approved in December 16, 2015[1] states that “pre-determination is not necessary” under Article 34 (1) for a certain amount of restricted-stock compensation. It also states that the amount of expense for the compensation “shall be deductible for the fiscal year that includes the day on which the (restricted stock) disposition limitation was lifted.” Accordingly, in the 2016 revision of the Corporation Tax Act, Article 34 (1) (ii) (pre-determined compensation) will be revised, and from April 1, 2016, it appears that corporations offering restricted stock will be able to include a certain amount in the deductible expenses. In other words, legislators are aware of the need for revising the tax law so as to not inhibit corporate governance; however, at present, the specific details of the provisions remain unclear.

4. Remaining Issues (asymmetry with respect to assessment of taxes for executives)

This is not to say that there are no problems with the revisions of the Act mentioned above. This is because there may be a difference between the total tax assessed for the executives and the total deduction included by the corporation as the expenses. This problem is already emerging for the stock options provided as compensation.

For example, let us say company A grants stock options to executive B with an exercise price of 1 yen in place of a salary of 1 million yen. When B exercises the stock options, if the share value is 5 million yen, the income tax is assessed at this stage as if B has earned compensation of almost 5

million yen (Order for Enforcement of the Income Tax Act, Article 84). However, company A can only claim 1 million in the deductions (Article 54 (1) of the Corporation Tax Act). In other words, this is an asymmetrical treatment of the executive and the corporation.

Even if the legal provisions concerning restricted stock are revised, the same type of problem may occur. On the date the disposition restriction is revoked, the executive will be taxed as if they had received compensation from the corporation (not taxed when the restricted stock was granted). The total compensation paid to the executive is the current market value of the restricted stock (5 million yen in the example of the stock option to executive B). However, it is anticipated that what the corporation can include in the deductible expenses will not be this market value of the restricted stock, but the value of the restricted stock when it was granted as executive compensation (1 million yen in the example of the stock option).

If the 2016 revisions concerning restricted stock permits such an asymmetrical taxation, the law (including Article 54 (1) of the Corporation Tax Act concerning stock options) should be further revised in the future.

(On 8 March 2016)