[Agreed Note of the Negotiators]

The Convention between the Government of Japan and the Government of the United States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, signed on November 6, 2003, contains rules allocating taxing jurisdiction over salaries, wages and other similar remuneration between Japan and the United States. The provisions of paragraph 10 of the Protocol to the Convention address the treatment under the Convention of employees benefiting from "stock option plans." Paragraph 10 includes a rule that allocates taxing jurisdiction over the benefits enjoyed by employees under stock option plans relating to the period between grant and exercise of an option between the two countries in order to avoid double taxation. In cases where double taxation nevertheless may arise because of the interaction of the domestic tax rules of Japan and the United States, paragraph 10 further provides that the competent authorities will endeavor to resolve any difficulties or doubts by way of mutual agreement with the aim of ensuring no unrelieved double taxation.

The interaction between the domestic taxation rules regarding the treatment of stock options in Japan and the United States can be complex. The rules of the Convention, in particular the rule included in paragraph 10 of the Protocol, that allocate taxing jurisdiction may not be enough to avoid double taxation in all cases. The purpose of this Understanding is to establish a framework by which double taxation can be avoided to the maximum extent possible as provided for in paragraph 10.

The tax treatment in each country of stock options provided to employees is similar to that in the other country. Generally, in each country the tax treatment depends on whether stock options meet specified requirements and conditions and therefore are considered so-called "qualified" stock options. The recipient of qualified stock options is not taxed at grant or on exercise of the option. Instead, the recipient is taxed only on sale of the stock. The recipient of "nonqualified" stock options generally is taxed on exercise of the option and on sale of the stock.

There are some differences between the tax treatment in each country of stock options provided to employees. For example, in Japan nonresidents generally would be subject to tax under its domestic tax law on the gain from sales of stock acquired through the exercise of stock options qualified in Japan. In the United States nonresidents (other than U.S. citizens) generally would not be subject to tax on the gain from sales of stock acquired through the exercise of qualified stock options even if they had been residents at the time of grant or exercise.

Article 14 of the Convention allocates taxing jurisdiction with respect to salaries, wages and other similar remuneration derived by a resident of one country in respect of an employment by providing generally that the other country (the "source" country) may tax such income if the employment is exercised in such source country and certain other conditions are met. Paragraph 10 of the Protocol provides that the benefits enjoyed by employees under stock option plans relating to the period between grant and exercise of an option are regarded as "other similar remuneration" for the purposes of Article 14.

Paragraph 10 of the Protocol further provides that the source country may tax only that proportion of such benefits which relates to the period or periods between the grant and the exercise of the option during which the individual has exercised the employment in that source country. Neither Article 14 nor paragraph 10 of the Protocol provides rules regarding when or in what manner the source country may tax such income. The source country may tax such income or may choose to forego taxation of such income in some or all circumstances. For example, Japan as the source country may tax such income upon the sale of the stock acquired through the exercise of a qualified stock option, and the United States as the source country may tax such income earned by non-resident citizens without resort to subparagraph (a) of paragraph 4 of Article 1. The limitations in Article 13 on the taxation of gains on the sale of stock by nonresidents are not relevant to the taxation of such income because paragraph 10 of the Protocol provides that such income is regarded as "other similar remuneration" for the purposes of Article 14. Under Article 23, any tax imposed by the source country on a resident of the other country on such income in accordance with the Convention, including Article 14 and paragraph 10 of the Protocol, shall be allowed as a credit against the tax imposed on that resident by the country of residence, subject generally to domestic law limitations on the foreign tax credit in the country of residence (as discussed below).

Our detailed discussions related to the treatment of stock options under the Convention were aided by consideration of the fact patterns in the attached annex. In many cases, the rules in the Convention, in particular the rule included in paragraph 10 of the Protocol, that allocate taxing jurisdiction between Japan and the United States, in combination with the domestic law foreign tax credit provisions of Japan and the United States, operate to eliminate any potential for double taxation. For example, the rules in the Convention that allocate taxing jurisdiction, in combination with the domestic law foreign tax credit provisions, eliminate any potential for double taxation in the cases in which stock options are treated consistently by both the tax law of Japan and the tax law of the United States either as nonqualified stock options or as qualified stock options

In the remaining cases, the domestic law foreign tax credit provisions of Japan and the United States and the rules in the Convention, in particular the rule included in paragraph 10 of the Protocol, that allocate taxing jurisdiction between Japan and the United States may not operate to completely alleviate double taxation. In these cases, while Article 14 and paragraph 10 of the Protocol allow the source country to tax certain income and Article 23 obligates the country of residence to allow such tax as a credit against the tax imposed on that resident by the country of residence, the limitations in the domestic law foreign tax credit provisions (such as limitations related to carryforward or carryback periods and limitations related to differences in the characterization of items of income or gain) operate in a manner that may prevent the alleviation of double taxation in cases where the treatment of the stock options under the domestic tax law of one country is different than the treatment in the other country. With respect to these cases, pursuant to paragraph 10 of the Protocol, the competent authorities of Japan and the United States will, through a mutual agreement procedure, provide measures for the elimination of double taxation at the time of sale of the underlying stock, including the allowance of a foreign tax credit for taxes paid to the source country at the time of exercise or sale that are imposed in accordance with Article 14 and paragraph 10 of the Protocol. The limitations in the domestic law foreign tax credit provisions of Japan and the United States will not prevent the alleviation of

double taxation in these cases due to the provision of measures for the elimination of double taxation by the competent authorities through the mutual agreement procedure. Thus, the provision of measures for the elimination of double taxation, including a foreign tax credit, by the competent authorities through the mutual agreement procedure in these cases will eliminate any potential for double taxation.

There may be other cases relating to stock options that raise double taxation issues. In these other cases, the competent authorities of Japan and the United States, as provided for in paragraph 10 of the Protocol, will explore ways to reach appropriate agreement through the mutual agreement procedure on a case-by-case basis with the aim of ensuring no unrelieved double taxation.

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ANNEX

These fact patterns were developed to aid the discussion related to the treatment of stock options under the Convention.

Each fact pattern below is based on the following common facts:

- A stock option with a price of option 15, which is equal to the value of the stock, is granted to an employee.
- The employee exercises the option in 5 year, acquiring the stock for 15. At the time of exercise, the value of the stock is 20.
- The employee sells the stock for 40 in a subsequent year.
- The employee is a resident of, and performs services in, either Japan or the United States throughout the period between grant and exercise.
- The employee is a resident of either Japan or the United States in the year the stock option is exercised and in the year the stock is sold.

Fact pattern 1. The employee is a resident of Japan in the year of exercise and the year of sale. The period between grant and exercise is five years; the employee is a resident of, and performs services in, the United States for four of those years and Japan for one of those years.

Fact pattern 2. The employee is a resident of the United States in the year of exercise and the year of sale. The period between grant and exercise is five years; the employee is a resident of, and performs services in, Japan for four of those years and the United States for one of those years.

Fact pattern 3. The employee is a resident of Japan in the year of exercise and a resident of the United States in the year of sale. The period between grant and exercise is five years; the employee is a resident of, and performs services in, the United States for four of those years and Japan for one of those years.

Fact pattern 4. The employee is a resident of the United States in the year of exercise and a resident of Japan in the year of sale. The period between grant and exercise is five years; the employee is a resident of, and performs services in, Japan for four of those years and the United States for one of those years.

There are four alternatives under each fact pattern, resulting in 16 possible general cases. In the first alternative, the stock option is regarded as nonqualified under the tax laws of both the United States and Japan. In the second alternative, the stock option is regarded as qualified under the tax laws of both the United States and Japan. In the third alternative, the stock option is regarded as nonqualified under the tax law of the United States, but is regarded as qualified under the tax law of Japan. In the fourth alternative, the stock option is regarded as nonqualified under the tax law of Japan, but is regarded as qualified under the tax law of the United States.

In cases resulting from the first and second alternatives, the rules in the Convention, in particular the rule included in paragraph 10 of the Protocol, that allocate taxing jurisdiction between Japan and the United States, in combination with the domestic law foreign tax

credit provisions of Japan and the United States, operate to eliminate any potential for double taxation.

In some of the cases resulting from the third and fourth alternatives the rules in the Convention, in particular the rule included in paragraph 10 of the Protocol, that allocate taxing jurisdiction between Japan and the United States, in combination with the domestic law foreign tax credit provisions of Japan and the United States, also operate to eliminate any potential for double taxation. However, in the remaining cases, the domestic law foreign tax credit provisions of Japan and the United States (including limitations related to carryforward or carryback periods and limitations related to differences in the characterization of items of income or gain) and the rules in the Convention, in particular the rule included in paragraph 10 of the Protocol, that allocate taxing jurisdiction between Japan and the United States may not operate to completely alleviate double taxation. With respect to these cases, pursuant to paragraph 10 of the Protocol, the competent authorities of Japan and the United States will, through a mutual agreement procedure, provide measures for the elimination of double taxation at the time of sale of the underlying stock, including the allowance of a foreign tax credit for taxes paid to the source country at the time of exercise or sale that are imposed in accordance with Article 14 and paragraph 10 of the Protocol.