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**LEGAL**  
**500**

**COUNTRY  
COMPARATIVE  
GUIDES 2022**

# The Legal 500 Country Comparative Guides

## Japan

# EMPLOYEE INCENTIVES

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This country-specific Q&A provides an overview of employee incentives laws and regulations applicable in Japan.

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# JAPAN

## EMPLOYEE INCENTIVES



### 1. What kinds of incentive plan are most commonly offered and to whom?

The types of incentive plans may include money, stock, stock options, and other kind. As for stock incentive plans, stock options were commonly used in the past; but it has been more common to use stock itself, especially stock compensation to directors.

The scope of employees entitled to such incentive plan (in addition to management and directors) varies, depending on the size and design of each company. Some companies provide such incentive plan only to senior employees, such as executive directors, while other companies provide to all the employees.

It might be worth noting that there are some institutional investors that have expressed their opposition to introducing an incentive plan using stocks and stock acquisition rights for non-executive officers (such as auditors and outside directors) assuming the independence requirement for them, which remains a subject of discussions. It is also worth noting that it is required to design the incentive plan in the way not to violate the regulations under the Labor Standards Act ("LSA"). For example, it is required for employers to pay wages in currency; and therefore incentive plans should be provided as additional monetary benefits to the employees (also, see #9(v) below).

### 2. What kinds of share option plan can be offered?

Stock options are commonly used. In this regard, it should be noted that, the amended Japanese Companies Act, which came into force in March 2021, does not require any monetary payment in the issuance of shares which are provided as remuneration to directors and executive officers of listed companies. As a result, while stock options of JPY 1 (i.e., stock options which requires the payment only of JPY 1 at the time of the exercise of the rights, so-called "1-yen stock options") were often used in practice, it is now allowed to issue to directors

and executive officers of listed companies the stock options which do not require any payment at the time of the exercise of the rights. It should be noted, however, it is not allowed to issue such stock options to corporate officers or employees).

### 3. What kinds of share acquisition/share purchase plan can be offered?

Many kinds can be offered, including Board Benefit Trust (BBT), Employee Stock Ownership Plan (ESOP), Restricted Stock (RS), Performance Shares (PS), Restricted Stock Units (RSU) and Performance Share Units (PSU) (also see #2 above for the details of the revision of the Companies Act concerning the issue of shares without requiring payment at the time of the exercise).

### 4. What other forms of long-term incentives (including cash plans) can be offered?

Forms other than those mentioned in #2 and #3 above can also be offered, including monetary compensation, like Performance Cash, Phantom Stock, and Stock Appreciation Right (SARs).

### 5. Are there any limits on who can participate in an incentive plan and the extent to which they can participate?

There is no particular limitation under the Japanese law. Incentive plans are basically designed at the discretion of each company. As for the scope of employees, see #1 above.

### 6. Can awards be made subject to performance criteria, vesting schedules and forfeiture?

Yes. In designing the incentive plans, lots of variations can

be used for performance criteria, such as (i) index of the entire company and/or of individuals, (ii) index of the stock market price and/or other financial indicators, and (iii) the performance timeframe. Forfeiture can also be used; for example, it could be provided by stipulating the rules which allow the company to obtain the granted rights free of charge (i) if the person to be granted is sentenced to imprisonment or severer punishment, (ii) if bankruptcy proceedings, etc. are commenced for him/her, or (iii) if he/she violates internal rules.

### 7. Can awards be made subject to post-vesting and/or post-employment holding periods. If so, how prevalent are these provisions both generally and by reference to specific sectors?

Yes. There is no specific provision which restricts such conditions for incentive plans. However, it cannot be said to be widely used in Japan.

### 8. How prevalent malus and clawback provisions are and both generally and by reference to specific sectors?

In recent years, the necessity of establishing malus and clawback provisions in the incentive system has been discussed, especially for the event of significant accounting revisions and fraud or massive losses. However, it cannot be said that these clauses have become prevalent in Japan while some companies do introduce them in their incentive plans.

### 9. What are the tax and social security consequences for participants in an incentive plan?

- i. **on grant;** No tax nor social insurance contribution will be imposed.
- ii. **on vesting;** If an employer pays monetary awards (including the case of providing vested shares and stock options without restriction of transfer) under an incentive plan, they are subject to taxation as employment income. On the other hand, no tax is imposed in case of vested shares and stock options with restriction on transfer. To pay monetary awards under an incentive plan will cause some social insurance contributions. To issue shares as incentive awards will also cause some social insurance contributions, because

shares as incentive awards fall within the definition of "remuneration" under Health Insurance Act and Employees' Pension Insurance Act, which is the basis of calculation of social insurance contributions. On the other hand, to vest stock options will not cause any social insurance contributions, because stock options do not fall within the definition of "remuneration".

- iii. **on exercise;** If an employee exercises "tax-qualified" stock options to obtain shares, no tax will be imposed on this exercise. However, if an employee exercises "non-tax-qualified" stock options to obtain shares, then he/she will be subject to taxation on employment income. In terms of social insurance, see #9(ii) above. In addition, to exercise stock options and obtain shares will not be subject to social insurance.
- iv. **on the acquisition, holding and/or disposal of any underlying shares or securities; and** Taxation on employment income will occur when the company, which has issued stock options or shares with restriction on transfer, approves the employee holding the stock options or shares to transfer them. After that, when the employee in fact transfers them, the capital gain (if any) shall be subject to taxation. In addition, if the employee disposes the stock due to exercise stock option regardless of "tax-qualified" or not, the capital gain shall be subject to taxation. On the other hand, merely holding shares or stock options will cause no tax. The acquisition, holding and/or disposal of any underlying shares or securities will not cause any social insurance contributions.
- v. **in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.** If an employer lend money to its employee to purchase shares or stock options as incentive awards on non arm's length basis, such loan might be characterized as wages; and wages will be subject to tax and social insurance. It should also be noted that the LSA prohibits the offset of wages against the amount to be paid in exchange for obtaining shares or stock options.

## 10. What are the tax and social security consequences for companies operating an incentive plan?

1. **on grant;** No tax will be imposed.
2. **on vesting;** If a company pays monetary awards (including the case of providing vested shares and stock options without restriction of transfer) under an incentive plan, the amount thereof will be deductible from taxable income of the company. On the other hand, no expense nor loss is recognized in case of vested shares and stock options with restriction on transfer.
3. **on exercise;** If an employee exercises "tax-qualified" stock options to obtain shares of a company, no expense nor loss will be recognized on this exercise. On the other hand, if an employee exercises "non-tax-qualified" stock options to obtain shares, then the market value of the stock option on grant will be deductible from taxable income of the company.
4. **on the acquisition, holding and/or disposal of any underlying shares or securities;** When a company which has issued its stock options or shares with restriction on transfer approves the employee holding the stock options or shares to transfer them, then it will be deductible expense/loss from tax base of the company. On the other hand, even if an employee holds or disposes shares or stock options, it will cause no taxational consequence on the company.
5. **in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.** Please see #9 above.

## 11. What are the reporting/notification/filing requirements applicable to an incentive plan?

Please see #15 and #18 below.

## 12. Do participants in incentive plans have a right to compensation for loss of their awards when their employment terminates? Does the reason for the termination matter?

It varies depending on the structure of incentive plan. You can design the incentive plan where the participants are not entitled to any right of compensation for loss of their awards when their employment terminates regardless of the grounds. You can also design the incentive plan where, for example, employee whose employment is terminated with cause has no right while employee whose employment is terminated without cause has some right.

## 13. Do any data protection requirements apply to the operation of an incentive plan?

Not specifically to the incentive plan. Companies are required to comply with the data protection requirements under the Act on the Protection of Personal Information, which applies to all the personal information handled by the companies, not only those held/used for incentive plan purpose.

## 14. Are there any corporate governance guidelines that apply to the operation of incentive plans?

The Corporate Governance Code, established by the Tokyo Stock Exchange, stipulates that "the remuneration of the management should include incentives such that it reflects mid- to long-term business results and potential risks, as well as promotes healthy entrepreneurship" (Principle 4-2 concerning the Roles and Responsibilities of the Board). In addition, the Supplementary Principle 4-2-1 stipulates that "the board should design management remuneration systems such that they operate as a healthy incentive to generate sustainable growth, and determine actual remuneration amounts appropriately through objective and transparent procedures. The proportion of management remuneration linked to mid- to long-term results and the balance of cash and stock should be set appropriately." While many companies have complied with these principles, this issue still has been one of the challenges for a lot of Japanese listed companies.

## 15. Are there any prospectus or securities

### law requirements that apply to the operation of incentive plans?

Yes, in case the shares or stock options of listed companies are used as incentive awards. When issuing shares or stock options, the listed companies might be required to disclose such issuance in the annual securities reports and/or any other types of disclosure documents. Even after issuing shares or stock options, the listed companies might be required to annually disclose information thereof, including, for example, who possess shares or stock options and how many and what kind of shares or stock options the holders possess.

### 16. Do any specialist regulatory regimes apply to incentive plans?

The Corporate Governance Code encourages incentive plans so that they could incentivize executives to realize their wholesome entrepreneurship by reflecting long-term performance and risks of business to their incentive awards. Please see #14 above.

### 17. Are there any exchange control restrictions that affect the operation of incentive plans?

Foreign Exchange and Foreign Trade Act of Japan requires prior or ex-post-fact notifications to very small scopes of “direct inward investment” (possibly including acquiring shares of Japanese companies) and “outward direct investment” (possibly including acquiring securities issued by foreign companies). However, as the scope of such notification requirements is set mainly in order to preserve Japanese national security, international peace and security and Japanese economy, it seems they seldom apply to incentive plans.

### 18. What is the formal process for granting awards under an incentive plan?

Under Japanese Company Act, if an employee concurrently holds the status of a director, the company needs a resolution of its shareholders meeting to grant awards to that employee, regardless of the kind of awards (i.e., whether the awards are monetary or not). In addition, if a company aims to grant shares or stock options to its employees as incentive awards, the company is required to have a resolution of its Board of Directors or (if it does not have its Board of Directors or in case of favorable issuance) its shareholders meeting to issue shares or stock options. Certain points of information of issued shares or stock options shall be

registered on the company registry.

### 19. Can an overseas corporation operate an incentive plan?

Yes. An overseas corporation can operate an incentive plan to employees located in Japan. We do not see any specific Japanese regulations that restricts such cases. It should be noted, however, that it might be required to check other general regulations such as foreign exchange law (see #17 above) and securities law (see #15 above).

### 20. Can an overseas employee participate in an incentive plan?

Yes. Japanese company can operate an incentive plan to overseas employees. We do not see any specific Japanese regulations that restricts such cases. It should be noted, however, that it might be required to check other general regulations such as foreign exchange law (see #17 above) and securities law (see #15 above).

### 21. How are share options or awards held by an internationally mobile employee taxed?

As far as Japanese domestic tax law is concerned, whether the mobile employee is taxed for share options or awards will depends on whether that employee has his/her “residence” in Japan or not. If yes, all income gained (not only those gained in Japan but also those gained in other jurisdictions) shall be subject to taxation in Japan. On the other hand, if that employee is a resident of other jurisdictions outside of Japan, then the Japanese domestic tax law taxes only on his/her “domestic Source Income” in Japan. Usually, the portion of his/her income pertaining to his/her services performed physically within Japan (if any) will be subject to taxation in Japan. It applies not only to cash-based awards but also to capital gain of stock options or shares as incentive awards.

It should be noted, however, that the actual consequence should be highly influenced by tax treaties between Japan and the relevant foreign jurisdictions (if any).

### 22. How are cash-based incentives held by an internationally mobile employee taxed?

Please see #21 above.

**23. What trends in incentive plan design have you observed over the last 12 months?**

Just as in other jurisdictions, there has been a trend of incentive plans using indices relating ESGs also in Japan.

**and proposals for reform that will affect the operation of incentive plans over the next 12 months?**

Company Act of Japan was amended in 2021 to ensure transparency in deciding awards for directors, though it seems too minor to materially affect the operation of incentive plans. In terms of amendment of Company Act, also see #2 and #3 above.

**24. What are the current developments**

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