The Legal 500 Country Comparative Guides

Japan: Employee Incentives

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

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

The business environment in Japan has changed drastically since the bubble years. Changes such as the downsizing of companies, increase of the number of foreign competitors and creation of joint venture enterprises with foreign companies increased pressure on the management of labor costs. Such changes have also affected the style of employment in the country, affecting not only the classical life-time employment style, but also mid-career employment. Under this movement, a number of companies have started adopting a variety of incentive plans; some of them expecting from employees a recognizable performance development in the short term.

An incentive plan commonly adopted by Japanese companies is the payment of a bonus. The bonus scheme is usually calculated based on the performance of the employees. According to statistics recently published by the Japanese government, 90% of Japanese companies have a bonus plan in place and 95.7% of such companies have actually paid the bonus. Among such companies, more than 50% have taken into consideration the individual performance of the employee for granting the bonus. The employee’s performance is measured mainly based on his/her level of achievement of goals, which is normally assessed during the course of HR evaluation procedures. There are several criteria utilized by companies for assessing an employee’s performance, such as points prorated by seniority, title, ability/skill and performance towards the objectives of work, which are typically established in the process of evaluation.

In addition to the payment of a bonus, Japanese companies listed on stock exchanges commonly offer share options to their employees. Roughly speaking, approximately 95% of Japanese listed companies have adopted a share purchase plan as an incentive plan for their employees. In the case of overseas corporations holding a subsidiary or an affiliate in Japan, different types of share plans in their jurisdictions are commonly offered to the employees in their jurisdictions.

Although it is not so common in Japan when compared to the performance bonus and share option plans explained above, a “profit sharing” scheme also is an option for Japanese companies. Under such an incentive plan it is possible to implement a bonus scheme by which the funds to be allocated for the payment of a bonus to employees are calculated based on the company’s profits by multiplying a certain percentage to the business profit. Generally, the payment will be made in a same way as a cash bonus, i.e., annually or semiannually in cash.

Some companies have implemented the Japanese ESOP (Employee Stock Ownership Plan) scheme, mainly by utilizing their existing share purchase partnerships by the employees. Although there was a movement to encourage companies to implement an ESOP around year 2000, the ESOP is not yet recognized as a major scheme for incentive plans.

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

   There are various types of share options available in Japan; however, in practice, the two most common share options alternatives are the following:

   1. granting of an option to the employees and/or directors to exercise the right to purchase shares at a price equal to or slightly below the market price on or immediately before the grant date. In substance, this type of option is supposed to be an incentive plan to improve the company’s performance. It is common to set a forfeiture condition, forfeiting the right granted by the option when the employee no longer has an employment relationship with the company, for instance, in case of termination of the employment; and
   2. granting of an option to the employees and/or directors to exercise the right to purchase shares at a lower price than the market price. In substance, this type of option is supposed to be used to pay a wage-related compensation such as a retirement allowance. It is common to set an exercise condition, for instance, the retirement of the holder of the right.

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

   The traditional type of employee share purchase plan is the scheme of an employee shareholding partnership provided by the Japanese Civil Act. Under such a plan a small amount of contribution is deducted from the employees’ salaries on a regular basis for the purchase of stock of the company via the partnership. The employees are entitled to receive dividends in proportion to their contribution to the capital stock.

   As mentioned above, some companies have implemented a scheme so called a “Japanese ESOP” under which employees can obtain shares utilizing certain financial instruments such as a trust. Regardless of the name “ESOP”, this scheme is different from an ESOP as is utilized in the USA for which a specific law is enacted. A Japanese ESOP is considered as a general term of financial instruments which are particularly developed for companies willing to grant the company’s shares to employees.

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

   In a conservative payment scheme, age is considered the most significant factor for determining the employees’ position in the rank-hierarchy and it reflects their wages, especially the base salary scheme. It is considered one of the core elements of the life-time employment style and is connected to the long term incentive for employees since the length of service period tends to be proportional to the increase of salary. There are numerous companies that still adopt such a payment scheme, especially in the manufacturing industry. A retirement allowance system could be a form of long-term incentive since the retirement allowance reflects the service period. Looking at the bonus scheme, Japanese companies have changed their trends of bonus scheme from long-term incentive to short-term incentive such as bonus linked to individual performance.

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

No limits on participants. Non-employees, such as non-employee directors and consultants, can participate. Companies have discretion over to whom an incentive plan is offered as long as each plan is offered on the same conditions to all participants. In practice, however, many companies have forfeiture conditions such as the termination of employment condition or retirement of the employee in their incentive plans. In that sense, in the standard incentive plans, having a connection with the company, such as employment and/or director, is the threshold requirement for participation of an individual in such plans.

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

In most Japanese companies, awards are a separate issue from the other incentive plan alternatives such as bonus and share option plans. Awards may be considered as proof of excellent performance but will not be subject to performance criteria, vesting schedules and forfeiture.

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?**

Awards can be made subject to post-vesting and/or post-employment holding periods. Some, but not many, companies have introduced these provisions. They are providing such awards mainly to senior employees such as manager level or more senior positions. We have not seen any significant difference between sector and industry but generally speaking we find that it is mostly global companies that introduce these awards based on the global program offered by their group companies.

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

Recently, malus and clawback provisions are actively discussed in Japan as conditions of remuneration for officers of listed companies. The number of companies which actually implement these conditions is increasing especially among major financial institutions and other global companies. It is expected that this trend will continue for a while among listed companies given that implementation of incentive plans for officers are likely to increase due to the introduction of the Corporate Governance Code in 2018.

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

In relation to the payment of the bonus, they are subject to income tax and the employer company is required to withhold such tax from the bonuses. In addition, contributions to the national social and labor insurance systems are required when the participants receive the bonuses. If an employee receives a payment from the profit sharing plan mentioned above, the payment received is also subject to income tax and social security contribution.

In relation to the stock option, the taxation is as follows:

1. on grant;
   No taxable income and social security contribution.
2. on vesting;
   No taxable income and social security contribution.
3. on exercise;
   Taxable income.
   The formula for calculating the amount to be taxed depends on the type of stock option. For example, if an employee is able to acquire listed shares by exercising the options, the taxable amount is the amount deducted from the market price of the listed shares by a certain amount.
   On the other hand, stock options that satisfy certain conditions, such as transfer restrictions, are not subject to taxation at the time of exercise.
   The exercise of stock options is not subject to social security contribution.
4. on the acquisition, holding and/or disposal of any underlying shares of securities;
   The acquisition and holding of any underlying share of securities are not subject to income tax. On the other hand, when the share is sold, the income from the disposal is subject to income tax.
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.
   There is no special taxation system for borrowing related to stock options.

If the employee’s stock ownership plan uses a partnership, the partnership itself is not subject to taxation. Income tax will be imposed directly to the individual who is a member of the partnership in the event of disposal of the acquired stock.

With regard to an ESOP, the Japanese National Tax Agency (“NTA”) has published their answer regarding its taxation. The fact is that the ESOP trust acquires all the shares that the Employee Shareholding Partnership is planning to acquire in the future, sells it to the Employee Shareholding Partnership on a regular basis, profits from the sale of the stock and distributes it to the employees after the trust period expires. NTA understands that the payment of dividends to employees under this plan is subject to income tax.

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

In relation to the payment of a bonus, the payment is deductible. On the other hand, if the bonus is paid to an officer, in principle, the payment is not deductible in order to prevent the officer from manipulating the amount of the company's income. The companies are required to withhold tax and social security contributions from the payment of bonuses.

In addition, if a company adopts the profit sharing plan mentioned above, the company also is required to withhold tax and social security contributions from the payment made under the profit sharing plan.

In relation to the stock option, the taxation is as follows:

1. on grant;
   Not deductible.
2. on vesting;
   Not deductible.
3. on exercise;
   Deductible, if any.
4. on the acquisition, holding and/or disposal of any underlying shares of securities;
   The acquisition and holding of any underlying shares of securities are not deductible. On the other hand, when shares are sold, the acquisition cost is deductible.
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.
   There is no special taxation system for borrowing related to stock options.

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

[Disclosure]

When the employer is a public company (i.e., a company whose shares are transferrable without restriction), a summary of stock options allocated to officers is required to be disclosed in the business report, a mandatory document under the Companies Act and where the general business activities of the company are reported to the shareholders.

In the case of listed companies, under the Financial Instruments and Exchange Act (which is a securities law in Japan), information regarding stock options shall be disclosed in a security report, a mandatory document for such companies in which certain facts and data of annual business performance are disclosed, mainly for the investor's analysis. In practice, the listed companies disclose the same information required to be disclosed in the business report (i.e., summary of stock options allocated to officers) to simplify the process. Information regarding an ESOP and/or shareholding membership needs to be disclosed in the security report as well.

[Filing]

When offering share options as incentive plans to 50 employees or more, a securities notice or securities registration statement generally must be filed with the *Kanto* Local Finance Bureau before the offering when the following conditions are met:

- Securities Notice:
  the total value of the share options is more than JPY 10 million but less than 100 million.
- Securities Registration Statement:
  the total value of the share option is JPY 100 million or more.

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?**

Participants in incentive plans do not have any right to compensation for loss of their awards when their employment is terminated. Far from it, companies may stipulate that employment termination is a condition of forfeiture of the incentive plan's rights. In this sense, it is difficult to see a right of employees in a common incentive plan as a definite legal right in Japan since right in a common incentive plan involves conditions to vest and/or exercise and rely upon the discretion of the company.

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

When an incentive plan takes into account personal data such as individual performance review, such data should be protected by law, the Personal Information Protection Law ("PIPL"), under which a company may not disclose such data without the consent of that person.

Due to the global movement of personal information protection, the Japanese PIPL has been changing in recent years. In particular, the implementation of the European General Data Protection Regulation (GDPR) in 2018 caused a significant impact on the law changing in this area. In fact, aiming the harmonization with the GDPR, the Japanese PIPL has changed and started requiring strict measures and requisites for protection of personal information. In the labor and employment area, all Japanese companies are required to update and establish their own privacy policy and information management policy even installation of data protection systems in order to share employees' personal information among group companies.

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

There are no guidelines applicable to the operation of incentive plans.

15. **Are there any prospectus or securities law requirements that apply to the operation**

of incentive plans?

As described in 9 above, there is a disclosure requirement under the Financial Instruments and Exchange Act (which is the primary securities law in Japan) regarding incentive plans.

Further, in principle, when an ESOP is structured as a trust scheme using a share purchase partnership, the trust acquires the shares in order to sell the same to the partnership. Under the Financial Instruments and Exchange Act, in principle, such acquisition could fall under the transactions requiring a license to be implemented. However, the Financial Instruments and Exchange Act exempts an ESOP from the requirement of registration as a financial instruments business operator under certain conditions.

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

There are no specialist regulatory regimes applicable to incentive plans. The operation of incentive plans is regulated by internal policies which are stipulated by individual corporations and they normally take into account the qualification of specialist as a positive criterion; e.g., obtaining the qualification of CPA affects the benefits in incentive plans but there is no regulation on the operation of incentive plan arising from a specialist regulatory regime.

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

When a Japanese resident (i.e., Japanese employee) makes a payment to a non-resident outside of Japan (i.e., foreign parent company of an employer) in an amount exceeding JPY 30 million (or its foreign currency equivalent) in a single transaction, such transaction may have to be reported to the Bank of Japan after the transaction has been concluded.

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

There is not a particular formal process for granting awards under an incentive plan. It is common to define the process for granting awards in the company's internal policy or rules of employment which is normally a part of the employees' annual evaluation.

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

Yes. Overseas corporations are able to implement various incentive plans for employees of their Japanese subsidiaries or affiliates with reasonable flexibility. However, it is important to note that (i) the Japanese Companies Law does not apply to incentive plans implemented by a foreign parent company; and (2) the Japanese Labor Standards Act and other labor related laws and regulations may not apply to incentive plans implemented by a foreign parent company provided that such plans are kept separate from the employment contract and work rules. As result, the majority of overseas corporations holding Japanese subsidiaries offer incentive plans operated by the mother company, which is an overseas corporation, in the same manner of the original plan abroad.

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

Yes. Overseas employee can participate in incentive plans referred to herein. Practically speaking, however, Japanese companies tend to construct incentive plans for domestic use. Therefore, there are a limited number of companies that provide an incentive plain at the global level.

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

1. Resident and non-resident

There are two categories of individual taxpayers under the Japanese income tax law; resident and non-resident. A resident means an individual who has continuously lived in Japan for 1 year or more. A non-resident means an individual other than a resident.

“An internationally mobile employee” may be a non-resident, because she/he usually has not resided in Japan for a continuous period of 1 year or more. Thus, the issue in this question is taxation on non-resident.

2. Taxation on non-resident

Japanese source income of non-residents is taxed. In other words, income corresponding to work in Japan is subject to Japanese taxation.

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

Same as 19.

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

There have been no major trends over the last 12 months. METI has been encouraging Japanese companies to introduce incentive plans to board members’ compensation by publicizing a report titled “Guidebook for Introducing Incentive Plans as Board Members’ Compensation to Encourage Companies to Promote Proactive Business Management”. The amendments to the Corporate Tax Act in 2016, 2017 and 2019 relate to the implementation of incentive plans to directors and high management-level employees such as stock-based compensation and performance-based compensation.

24. **What are the current developments and proposals for reform that will affect the operation of incentive plans over the next 12 months?**

Recently, Japanese government has shown proactive behavior to strengthen corporate governance. In 2018, the Corporate Governance Code issued by Japan Exchange Group (self-regulatory organization) was revised and the requirements related to the transparency of holders of shares were increased. Furthermore, due to reform of the tax law in 2017, a tax privilege can be granted to the remuneration of officers when the calculation is linked to the company's performance and a 2019 tax reform changed the procedure for incentives to be deductible. Given these trends, it is likely that the companies will consider more seriously the implementation of incentive plans, including the granting of stock to employees and/or officers.