Japan Tax Bulletin

Restricted Stock Unit

December 2022

In Japan, legislation related to stock-based compensation has been developed in recent years, and an increasing number of companies are adopting stock-based compensation. Restricted Stock Units (RSUs), which are considered effective for retention and Long Term Incentives, became deductible under the 2017 tax reform.

1. *Definition of RSU*

RSUs are stock-based compensation that is based on the requirement of continuous service of a director or employee, and the number of shares is calculated based on a predetermined formula and delivered after the requirement has been met.

Compared to similar stock-based compensation, Restricted Stock (RS) is a pre-delivery type of stock award in which shares are delivered at the time of grant but dispositions of them are restricted until a designated date, while RSUs are different in that shares are not delivered at the time of grant of RSUs , but are delivered when vested after continuous services of a certain period. Performance shares (PS) are similar to RSUs in that shares are delivered upon achievement of certain conditions, but PSs are based on achieving a certain level of performance, whereas RSUs are based on continuous service.

The basic legal mechanism of share delivery is to deliver shares in exchange for capital contribution of employees/directors' monetary compensation receivables for services.

2. *Treatment on the recipient's side under the Income Tax Law*

(1) Income classification

Stock-based compensation, including RSU, is classified as either salary income or retirement income. Retirement income is a compensation paid upon retirement.

Retirement income has the following requirements:

- The benefit must be fixed at the time of retirement
- The benefit must be compensation for director's service or employee's labor.
- The payment must be lump-sum (not a pension).

Compensation that does not satisfy the above requirements is considered salary income.

Tax rates differ between salary and retirement income, and in many cases, for the same amount of compensation, the tax burden is lower for retirement income.

(2) Time for income recognition

If the delivery of shares is determined by continuous service up to a specific date, the said specific date (vesting date) is the time of income recognition. For example, if there is a provision that shares are to be delivered one year from the start of the service period, and the shares are actually delivered one year later, the date one year later is the time of income recognition.

If the specified date is the time of retirement, then the income is recognized at that time.

(3) Amount of income

The amount of income is the market value of the shares on the above specified date (vesting date) multiplied by the number of shares delivered.

(4) Withholding tax

When RSUs are delivered, withholding tax is required as salary or retirement income. If the company delivers only shares (no money), the tax must be collected in cash from the recipient or the tax must be calculated by gross-up method.

In the case where shares of the parent company are delivered upon the contribution in kind of compensation receivables (see 3(3)(iii)), the company receiving the services (subsidiary) grants compensation receivables to its directors or employees, and the directors or employees then contribute said compensation receivables in kind to the company issuing the shares (parent company). In such a case, the corporation granting the compensation receivables, or the subsidiary, is considered to be obliged to withhold tax.

(5) Disposition of shares

Where employees/directors have disposed of shares received under RSUs, the difference between a sales price and its tax basis, which is the value in (3) is taxed as capital gains separately from other income.

3. Treatment on the Company's side under the Corporate Tax Law

(1) Time for deductible expenses recognition

The compensation become deductible when it is fixed due to the expiration of the service period (vesting date). This is the same as the time for income recognition on the recipient's side.

(2) Deductible amount

The deductible amount of RSUs is the share price at the time of the grant multiplied by the number of shares delivered

It should be noted that costs for RSUs become deductible when vested for a company offering RSUs but the deductible amount is calculated based on a market value of shares when granted. In addition, the amount of the recipient's income is based on a market value of shares on the vesting date, which is different from the company's deductible amount.

In addition, the requirements of (3) must be met in order for the cost of stock-based compensation under RSUs to directors to be deductible.

(3) In the case that RSUs is delivered to directors

In the case of director's salary, either periodically fixed salary, fixed salary notified in advance or performance based salary is tax deductible. Other type of salaries are disallowed. Further, compensation paid on retirement is tax deductible as long as the amount is not excessive.

RSUs to directors can be designed as fixed salary notified in advance The requirements to fall under the category of fixed salary notified in advance are as follows:

(i) To submit an advance notification of fixed salary (see (4) below).

(ii) The salary must be actually paid based on the stipulation that a fixed number of shares are to be delivered.

(iii) The shares must be Qualified Shares.

Qualified Shares are shares that satisfy the following requirements:

A. The shares must be issued by the domestic corporation that is to receive the services (the corporation for which the director works) or its affiliated corporation, including overseas ones.

B. The shares must be listed shares with a market price (overseas listed shares are also acceptable).

Salaries to employees and retirement payments are not subject to the above restrictions and are fully deductible.

(4) Procedures for fixed salary notified in advance

The requirements of the notification for fixed salary notified in advance are as follows:

(i) Notification deadline

The earlier of the following dates:

A. The earlier of the date of resolution of the shareholders' meeting regarding the director's salary or the date one month after the date of commencement of the director's performance of duties

B. The date four months after the beginning of the accounting period

(ii) Items to be stated

- Name and position of the director
- The time of payment, the issue, the number of shares to be delivered, the market value of the shares as of the resolution date, the terms and conditions, and other details related to the grant
- Other corporate information