

# Treatment of stock-based compensation for social and labour insurance purposes

PwC Labor and Social Security Attorney Corporation



# Contents

Introduction – Overview of this material	3
1. Major classifications of stock-based compensation	4
2. Treatment of stock-based compensation under Japanese social insurance law	5
3. Treatment of stock-based compensation under Japanese labour insurance law	6
(Reference material) Definition of compensation under Japanese social insurance law	7
(Reference material) Treatment of compensation under Japanese social insurance law	8
(Reference material) Definition of wages under Japanese labour insurance law	10
(Reference material) Treatment of wages under Japanese labour insurance law (1/2)	11
(Reference material) Treatment of wages under Japanese labour insurance law (2/2)	12

# Introduction – Overview of this material

Recently, we at PwC Labor and Social Security Attorney Corporation have been receiving an increasing number of enquiries from clients about the treatment of stock-based compensation for Japanese social and labour insurance purposes. Since there are no clear provisions in the relevant laws, regulations or notices, we believe that many HR teams are struggling with how to handle the issue.

This material has been prepared to help you understand how such compensation is generally treated for Japanese social and labour insurance purposes.

Please note that the information contained in this material is general in nature and that the relevant authorities may take a different view to the issues discussed, depending on the specifics of the stock plan. We recommend that you seek specific advice from PwC Labor and Social Security Attorney Corporation or another external professional as appropriate before introducing any stock-based compensation plan.

# 1. Major classifications of stock-based compensation

	<u>Variations</u>	<u>Overview</u>
Ex-ante issuance type	Restricted stock (RS)	Restricted stock refers to shares that a company issues to its executives or employees that are under certain transfer restrictions until certain conditions, such as continued service/employment for a certain period of time, are met. The transfer restrictions are lifted upon vesting.
	Performance shares (PS)	Performance shares are shares with transfer restrictions that a company issues to its executives or employees in advance at the start of a performance evaluation period. The transfer restrictions are lifted according to the degree to which the pre-determined performance targets are achieved.
	Stock options (SO)	A stock option plan is a system in which a company grants its executives or employees the right to purchase the company's stock at a predetermined strike price. Options can be exercised after they vest.
Ex-post issuance type	Restricted stock units (RSU)	The RSU plan is a plan in which a company grants points called 'units' to its executives or employees in accordance with certain rules. After the executive/employee fulfills certain conditions, such as continued service/employment for a certain period of time, the company issues/pays them shares or cash according to the number of points they have earned.
	Performance share units (PSU)	The PSU plan is a plan in which a company grants a certain number of units to its executives or employees based on their position. The company then issues/pays them shares or cash calculated based on the rate of achievement of the performance targets after a certain performance evaluation period.

## 2. Treatment of stock-based compensation under Japanese social insurance law

Under the Health Insurance Act and the Employees' Pension Insurance Act, the issuance of shares to company executives or employees is construed as consideration for labour, and therefore counts as salary paid in kind.

	<u>Variations</u>	<u>Does it count as compensation or a bonus?</u>	<u>When is the compensation/bonus considered paid?</u>
Ex-ante issuance type	Restricted stock (RS)	Yes	When the transfer restrictions are lifted
	Performance shares (PS)	Yes	When the transfer restrictions are lifted
	Stock options (SO)	No	-
Ex-post issuance type	Restricted stock units (RSU)	Yes	When shares or cash are issued/paid
	Performance share units (PSU)	Yes	When shares or cash are issued/paid

Note: When shares are issued instead of cash, the value of the compensation/bonus is determined based on the share price as of the date of issuance.

### 3. Treatment of stock-based compensation under Japanese labour insurance law

Under the Labour Insurance Premiums Collection Act, the issuance of shares to company executives or employees is not considered the payment of wages (unless otherwise provided for in the labour agreement) and is therefore not subject to the collection of labour insurance premiums.

	<u>Variations</u>	<u>Does it count as compensation /wages?</u>	<u>Cautionary notes</u>
Ex-ante issuance type	Restricted stock (RS)	<ul style="list-style-type: none"><li>In principle, the relevant authorities interpret 'wages' for the purpose of the Labour Insurance Premiums Collection Act based on the definition of 'wages' under the Labour Standards Act, and collect premiums accordingly.</li><li>If the law or the collective labour agreement provides otherwise, these stock-based compensation plans may be considered wages. (Note 1)</li><li>In accordance with a past notice, stock options are not considered wages. (Note 2)</li></ul>	<ul style="list-style-type: none"><li>The comments in the column to the left are based on the views of multiple labour bureaus in the Tokyo metropolitan area that PwC confirmed through enquiries (as of October 2024).</li><li>What is stated in the left column is not stipulated in any legal provisions or notices (except for the stock options). If your company actually introduces any of these plans, we would recommend that you check with your local prefectural labour bureau regarding treatment.</li></ul>
	Performance shares (PS)		
	Stock options (SO)		
Ex-post issuance type	Restricted stock units (RSU)		
	Performance share units (PSU)		

Note 1: Article 24 of the Labour Standards Act states that 'wages must be paid in full and in money directly to the worker'. However, it also states that an employer may 'pay in a form other than money if so provided for by law or by the collective labour agreement or if it does so for the wages specified by an ordinance of the Ministry of Health, Labour and Welfare (hereinafter, 'MHLW') by a reliable method that is specified by an ordinance of the MHLW'.

Note 2: A worker who is granted a stock option decides whether or not to exercise the option, when to exercise it and when to sell the stock if they are to exercise it. As a result, the timing of when benefits accrue from this plan and the amount of the benefits are left to the discretion of the worker. Therefore, benefits derived from this plan are not consideration for labour and do not count as wages under Article 11 of the Labour Standards Act (1 June 1997, Notice No. 412 issued by the Director of the Labour Standards Bureau of the former Ministry of Labour).

# (Reference material) Definition of compensation under Japanese social insurance law

The Health Insurance Act and the Employees' Pension Insurance Act define 'compensation' and 'bonus' as 'anything that a worker receives as consideration for their labour'.

## Provisions of the Health Insurance Act and the Employees' Pension Insurance Act

### Article 3 of the Health Insurance Act

5 The term 'compensation' as used in this Act shall mean wages, salaries, pay, allowances, bonuses and any other things that a worker receives as consideration for their labour, regardless of the name given to it; provided, however, that this shall not apply to earnings received on a temporary basis or earnings received periodically at intervals of more than three months.

6 The term 'bonus' as used in this Act shall mean wages, salaries, pay, allowances, bonuses and any other things that a worker receives as consideration for their labour at intervals of more than three months, regardless of the name given to it.

### Article 3, paragraph 1 of the Employees' Pension Insurance Act

(iii) Compensation: it shall mean wages, salaries, pay, allowances, bonuses and any other things that a worker receives as consideration for their labour, regardless of the name given to it; provided, however, that this shall not apply to earnings received on a temporary basis or earnings received periodically at intervals of more than three months.

(iv) Bonus: it shall mean wages, salaries, pay, allowances, bonuses and any other things that a worker receives as consideration for their labour at intervals of more than three months, regardless of the name given to it.

# (Reference material) Treatment of compensation under Japanese social insurance law

## What is considered compensation

- In addition to considerations for labour actually provided, any payments that an employer makes to an employee on a regular basis (periodically) in accordance with pay regulations or other rules are considered 'compensation and the like'.
- The provision of labour and the payment of the consideration do not need to coincide in time; even considerations for future labour and allowances paid during short-term or long-term sickness absence count as considerations for labour and are therefore considered 'compensation and the like'.
- If an employer provides meals, housing, etc. to an employee based on the employment contract (i.e. salary in kind), such provision is also considered to be 'compensation and the like'.

- Wages
- Salaries
- Pay
- Bonuses
- Commuting allowances
- Dependency allowances
- Managerial position allowances
- Service-area allowances
- Leave allowances
- Allowances for absence from work

## What is not considered compensation

- Payments that are not received as a consideration for labour are not considered 'compensation and the like'.

Note: If a retirement allowance is paid in advance adding it on top of the monthly salary or bonus, it is reasonable to treat it as ordinary income to be used for the normal living of the insured person, and therefore such a retirement allowance counts as 'compensation and the like'.

- Sickness and injury benefits
- Compensation for loss of earnings during absence from work under the Industrial Accident Compensation Insurance Act
- Payment in lieu of notice
- Retirement allowances
- Income received from a source other than a social insurance-covered business establishment

- Anything provided by an employer as a favour is not recognised as consideration for labour and therefore does not count as 'compensation and the like' in principle.

Note: Even if an employer provides something as a favour, if it is provided based on the collective labour agreement or the like and is paid on a regular basis (periodically), it is considered 'compensation and the like'.

- Congratulatory and condolence allowances
- Monetary gifts for weddings
- Monetary gifts for farewells

- If an insured person pays expenses that should be borne by their employer in advance and gets reimbursed for the actual cost, such reimbursement is not recognised as consideration for labour and therefore does not count as 'compensation and the like' in principle.

- Business travel expenses
- Travel expenses for a new assignment

Excerpts of key points from '標準報酬月額の定時決定及び隨時改定の事務取扱に関する事例集' (Administrative notice issued by the Director of the Pension Service Management Division, Pension Bureau, MHLW on 27 June 2023)

# (Reference material) Treatment of compensation under Japanese social insurance law

## What is not considered compensation

Long-term service cash awards that meet all of the following requirements are considered to be paid as a favour and therefore do not count as compensation.

- Purpose of the award

The company provides the cash award as an employee welfare measure or an incentivising measure for long-term service. If refreshment leave is also granted in addition to the cash award, the award is considered to have an even stronger characteristic of employee welfare benefits.

- Criteria for the award

The cash award is paid uniformly to all eligible employees with the only requirement being the number of years of service.

- Form of payment

The amount of the cash award does not exceed the socially accepted range of the so-called congratulatory monetary gift. The intervals between the awards are approximately five years or more.

Excerpts from '標準報酬月額の定時決定及び隨時改定の事務取扱に関する事例集' (Administrative notice issued by the Director of the Pension Service Management Division, Pension Bureau, MHLW on 27 June 2023), partially edited by PwC

# (Reference material) Definition of wages under Japanese labour insurance law

Japanese labour insurance law defines 'wages' as 'anything paid by an employer to an employee as consideration for labour, such as wages, salaries, allowances and bonuses, regardless of the name given to it'.

## Provisions of the Labour Insurance Premiums Collection Act

### **Article 2 of the Labour Insurance Premiums Collection Act**

2 The term 'wages' as used in this Act shall mean wages, salaries, allowances, bonuses and any other things that an employer pays to an employee as consideration for their labour, regardless of the name given to it (except for payments made in a form other than money and outside the scope of wages specified by an ordinance of the MHLW).

### **Ordinance of the MHLW (Article 3 of the Ordinance for Enforcement of the Act on the Collection, etc. of Insurance Premiums of Labor Insurance)**

#### **Wages paid in a form other than money**

The scope of wages paid in a form other than money that should be included in the wages set forth in Article 2, paragraph 2 of the Act includes the benefits of meals, clothing and housing, and the rest shall be determined by the Head of the competent Labour Standards Inspection Office or the Head of the competent Public Employment Security Office.

# (Reference material) Treatment of wages under Japanese labour insurance law (1/2)

- Basic wages, such as base salary and fixed salary
- Overtime allowances, late-night work allowances, holiday work allowances, etc.
- Dependency allowances, child allowances, family allowances, etc.
- Night/day duty allowances
- Executive allowances, managerial position allowances, etc.
- Regional allowances, allowances for fuel use in cold districts
- Rent/housing allowances
- Education allowances
- Unaccompanied duty allowances (for employees living and working away from their family)
- Skill allowances
- Special work allowances (i.e. hazard pay)
- Bonuses
- Commuting allowances, commuter passes, coupon tickets

## What is considered wages

Incentive allowances	Good attendance allowances, perfect attendance allowances, etc.
Inflation allowances, cost of living support	Allowances paid to help with household finances
Allowances for absence from work	Allowances paid pursuant to Article 26 of the Labour Standards Act
Adjustment allowances	Adjustment allowances for reassignment, starting salary, etc.
Social insurance premiums and the like	When the company bears the portion that should be borne by the employee
Difference due to a retroactive pay raise	If the payment is determined while the employee is still employed and is made after they leave the company, it is considered wages.
Prepaid retirement allowances	If the payment criteria and amount are clear, a prepaid retirement allowance is considered wages.

# (Reference material) Treatment of wages under Japanese labour insurance law (2/2)

What is not considered wages	Executive compensation	Compensation paid to directors or the like
	Monetary gifts for weddings, condolence money on death, disaster relief money, seniority/length-of-service rewards, retirement allowances	These are not considered wages, regardless of whether they are provided for in work rules or a collective labour agreement.
	Travel and accommodation expenses	Expenses that are expected to be reimbursed at actual cost
	Tool/bedding allowances	Allowances paid for tools purchased at the employee's own expense
	Compensation for absence from work	This is based on Article 76 of the Labour Standards Act. Compensation for absence from work is not considered wages, including any amount exceeding the statutory rate of 60%.
	Sickness and injury benefits	This is based on Article 99 of the Health Insurance Act.
	Payment in lieu of notice	Allowances paid under Article 20 of the Labour Standards Act when an employer dismisses an employee without 30 days' advance notice before the date of dismissal
	Subsidies for employees' asset building schemes, etc.	A subsidy paid by an employer at a fixed rate or amount to support employees' asset building based on the Act for Promotion of Worker's Property Accumulation (subsidies for employees' asset building schemes), incentives for employee stock ownership plans, etc.
	Life insurance premiums	Where an employee is named as the insured person in a life insurance contract and the company pays the full amount of the insurance premiums, the payment is not considered wages.
	Home ownership incentive	If an employee gets a loan to purchase a home and the company pays interest subsidies at a certain rate or amount, the interest subsidies are not considered wages.
Benefit of being provided with housing (employee welfare facility)	If the company pays a housing equalisation allowance (i.e. allowance to maintain a balance between employees who are provided with housing and employees who are not) to employees who are not provided with housing, the benefit of being provided with housing may be considered wages.	