# Japan Tax Bulletin

## Restrictions on the deduction of excessive salary or retirement allowances paid to an officer

**March 2023**

The tax deduction for salary and retirement allowance paid to an officer of a company is disallowed when the amount of salary or retirement allowance is excessive. The reasoning behind this is that excessive salary or retirement allowance paid to an officer is construed as hidden distributions of profits rather than business expenses. The tax authority is generally not aggressive in determining whether salary or retirement allowance paid to an officer is excessive. Where the amount of salary or retirement allowance paid to an officer is significantly excessive with reference to services provided the officer, the tax authorities may challenge the deductibility.

*1. Officer*

An officer for tax purposes is much broader than a director and a statutory auditor under Company Law. An officer for tax purposes includes not only a director and a statutory auditor under Company Law but also a liquidator of a company and persons engaged in the management of a company. Where a resigned director of a company is still engaged in the management of the company as an advisor, such person is treated as an officer for tax purposes.

*2. Excessive Salary*

*(1) Formal Basis*

Under Company Law, a shareholders' meeting is authorized to determine directors' salary. Practically, after a company includes the maximum total amount of directors' salaries in its articles of incorporation or a shareholders' meeting resolves the maximum total amount of directors' salaries, the determination of each director's salary is delegated to the board of directors or a representative director.
The NTA (National Taxation Agency) has released the following Q&A:

"The shareholders' meeting of Company A has resolved that the annual maximum total amount of directors' salaries is JPY100,000,000 and delegated the determination of each director' salary to the board of directors. The board of directors has determined each director's salary amount as follows:

Director X (Representative Director): JPY1,000,000 per month
Director Y (Part-time): JPY100,000 per month
Director Z (Part-time): JPY100,000 per month
During a business year, Company A paid more than JPY12,000,000 to Director X, but the total directors' salary amount did not exceed the maximum total amount.

Director X's excess salary over JPY 12,000,000 would be disallowed as excessive director's salary.

*(2) Substance basis*

Officer's salary exceeding a reasonable amount as consideration for services performed would be disallowed. A reasonable amount as consideration for services performed is determined with reference to the officer's duties, profitability of a company, employees' salary level and officer's salary level at another company in the same or similar business as the company and of comparable business scale to the company.

*3. Excessive retirement allowance*

Officer's retirement allowance exceeding a reasonable amount would be disallowed. A reasonable amount is determined with reference to their period of service as officer, reasons for retirement and officer's retirement allowance levels at a company in the same or similar business as the company and of comparable business scale to the company.
Practically, the tax authorities use achievement multiplier methods to determine a reasonable amount and courts generally have upheld the reasonableness of such methods. Under the achievement multiplier methods, a reasonable amount is calculated as a final monthly salary amount x the number of years for service x an achievement multiplier. The achievement multiplier is [retirement allowance amount / (final monthly salary amount x the number of years of service)] of comparable companies. Usually, an average achievement multiplier of comparable companies is utilized. When an average achievement multiplier is not appropriate to calculate a reasonable retirement allowance amount, a maximum achievement multiplier of comparable companies may be used.

On March 23, 2006 the Okayama District Court Decision evaluated the achievement multiplier method as follows:

“The achievement multiplier in this average achievement multiplier method is a figure derived for each officer’s retirement salary based on the final monthly salary and years of service. The final monthly salary generally shows highest salary amount of an officer during years of service, it best reflects the officer’s contributions to the company during years of service as an officer. The years of service is considered to include factors to evaluate the nature of deferred salary and factors reflecting the officer’s contribution to a company during years of service. Therefore, the achievement multiplier derived by taking these factors into consideration is a comprehensive consideration of all circumstances that affect the calculation of retirement allowance, including the company's business scale and business performance. Therefore, the average achievement multiplier ratio method can be regarded as a judgment method that conforms to the intent of the above laws and regulations as long as examples of retirement allowance paid by comparable companies are extracted rationally.”

The tax authority collects comparable companies’ information through enquiries to other tax offices, which taxpayers are not allowed to access. As such, this inequity in the ability to access information, between tax authorities and taxpayers is sometimes criticized.