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Performance-Based Executive Pay and 2017 Japanese Corporate Tax Law Reform

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ABSTRACT

After the 2006 corporate tax law revision in Japan, regular fixed, pre-notified, and performance-based remunerations were designated as deductible expenses. The remaining remuneration is non-deductible. Performance-related remuneration paid by a domestic corporation that met specific conditions was deductible unless a portion of the remuneration was unreasonably expensive. The 2017 corporate tax law reform extended the definition of performance-based pay. This study used the 2017 corporate tax law reform to expand the definition of deductible performance-based pay as an exogenous shock. The number of firms accepting performance-related executive pay had increased because of the 2017 corporate tax law reforms. However, no evidence existed regarding investors welcoming reforms or increases in executive compensation. This can be explained by the efficient contracting theory. This study contributes to existing literature in several ways. First, it contributes to the literature on corporate taxes and executive compensation by focusing on Japanese events. The law reform was unique because it expanded tax deductions for executive compensation. Second, it elucidates the effects of revisions on corporate behaviour in the corporate governance literature. Finally, this study provides practical implications for Asian regulators and rule-making institutions where corporate governance is still developing.

1. INTRODUCTION

Executive compensation includes fixed and performance-based payments. In March 2015, the Japanese Financial Services Agency enacted a corporate governance code requiring effective business management. This code aimed to promote sustainable corporate growth and increase corporate value over the mid- to

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long-term because most executive pay in Japan was fixed compared to that in the West (Otomasa, 2015). Managers in Japanese firms were appointed through internal promotions within the company (Hamamura et al., 2024). The board should design management remuneration systems as incentives in the mid- to long-term (General Principle 4). Actual remuneration should be appropriately determined through objective and transparent procedures, the proportion of management remuneration linked to mid- to long-term results and the balance between cash and stock (Supplementary Principle 4.2.1). An environment that supports appropriate risk-taking by senior management as a major aspect of their roles and responsibilities should be established (General Principle 4). In addition, it should ensure that the appointment and dismissal of senior management are based on highly transparent and fair procedures through an appropriate evaluation of the company's business results (Supplementary Principle 4.3.1). Moreover, the Japanese government published the “Japan Revitalization Strategy” (https://www.kantei.go.jp/jp/topics/2015/seicho_senryaku/pdf1_new_seika_torikumi.pdf), which required that firms implement measures to use performance-related pay such as stock instead of cash completely to incentivise executives to increase firm value over mid- to long-term.

Under the corporate tax law, employee pay is deductible because it is expensive. However, executive pay is not always deductible. After the 2006 revision of the corporate tax law in Japan, regular fixed, pre-notified, and performance-based remuneration for executives were designated as deductible expenses. The remaining remuneration was non-deductible. Performance-related remuneration paid by a domestic corporation that met specific conditions was deductible, unless a portion of the remuneration was unreasonably expensive (Corporate Tax Law, Article 34(1) (iii)). The 2017 corporate tax law reform extended the definition of performance-based pay. This reform aligned with the aforementioned corporate governance reforms (Watanabe, 2023). Before the reform, the calculation indicator was based only on business-year profits. After the reform, indicators based on market prices of shares and sales were added. Additionally, the calculation time was extended from one business year to an accounting period that ended on or after the day of the commencement of the period during which the officer performed the duty. Moreover, after the reform, performance-based salaries included qualified shares or share options in addition to cash. However, performance-related deductions did not apply to family firms because directors determine directors' remuneration without involving non-family shareholders.¹ However, the effect of the 2017 corporate tax law reform on companies remained unclear. This study used the 2017 corporate tax law reform as an exogenous shock and empirically investigated its effects on firm responses using the difference-in-differences method. The number of firms accepting performance-related executive pay had increased because of the 2017 corporate tax law reforms. However, no evidence existed regarding investors welcoming reforms or increases in executive compensation.

This study contributes to existing literature in several ways. First, it contributes to the literature on corporate taxes and executive compensation by focusing on Japanese events. Second, it elucidates the effects of the revision on corporate behaviour in corporate governance literature. Finally, this study provides practical

¹A family company is a company where the total number of shares held by one group (not more than three of its shareholders and an individual and corporation that have a special relationship by Cabinet Order with these shareholders) is at least 50% of the total number of issued shares of the company (Corporate tax law Article 2(x)). However, this family firm excludes a 100% subsidiary company of a listed company.

implications for Asian regulators and rule-making institutions where corporate governance is still developing.²

The remainder of this paper is organised as follows. Section 2 reviews the relevant literature and develops our hypotheses. Section 3 describes the study's research design and presents the empirical results. Section 4 describes the additional tests. Finally, Section 5 concludes the study.

2. LITERATURE REVIEW

2.1 Tax Deductibility and Performance-Based Pay

In large firms, shareholders are dispersed, executives have high discretion regarding internal information, and they do not always pursue shareholder interests (Jensen & Meckling, 1976). Executive pay is important to incentivise the alleviation of agency problems. The extended definition of performance-based pay through the 2017 corporate tax law reform may alleviate this problem. After the reform, indicators based on market prices of shares and sales were included in the definition. Additionally, the calculation time was extended from one business year to the accounting period that ended on or after the day of the commencement of the period during which the officer performed the duty. Performance-based salaries also included qualified shares or share options in addition to cash after the reform. According to a 2018 survey conducted by Deloitte Tohmatsu Consulting LLC, which included 659 listed Japanese companies, the median total compensation increased by 2.2% for CEOs, 4.3% for directors, and 5.0% for outside directors compared to the previous year.³ Of the responding companies, 45% reported that they had already implemented stock-related compensation, representing a 4% increase from the previous year. The most commonly implemented system was stock option, used by 104 companies. In terms of future considerations, 165 companies were exploring the implementation of restricted stock, 105 were considering stock grant trusts, and 58 were examining performance shares. This indicated a growing interest in stock-related compensation beyond stock options. Additionally, the survey revealed that 40% of the responding companies had established voluntary compensation committees, a figure that was expected to rise. However, Suzuki (2021) pointed out the increased financial reporting costs as a problem with Japan's corporate tax law system for deducting performance-related executive compensation as expenses. To implement this system, companies must disclose the calculation methods in their securities reports. This requirement resulted in the disclosure of individual executive compensation amounts, which could provoke employees and/or business partners to demand a contract review. For instance, former Nissan chairman Carlos Ghosn reportedly sought to avoid disclosing his executive compensation in the securities report due to "a prevailing sentiment in Japan against large executive pay".⁴ Furthermore, excessive reductions in tax burdens can lead to consumer backlash and boycotts.

Durrant et al. (2021) investigated the effects of the Tax Cuts and Jobs Act (TCJA) of 2017 in Section 162(m) in the USA. Section 162(m) deemed executive compensation in excess of \$1 million as "excessive" and limited its deductibility, with an exception that \$1 million limit did not apply to performance-based compensation. The TCJA abolished this exception and ended the beneficial tax treatment of performance-

² Most large companies in Asia rarely link their executive pay to the performance of the companies' stock (Brealey, Myers, & Allen, 2014).

³ <https://www.smtb.jp/-/media/tb/about/corporate/release/pdf/181120.pdf>

⁴ *Nikkei Newspaper, Morning edition*, October 17, 2020

based compensation in 2017. Executives had a strong incentive to use the deduction of beneficial exceptions immediately before a revision. Therefore, increases in CEO bonuses and stock option compensation were significantly higher in 2017. The 2017 Japanese corporate tax law reform extended the definition of performance-based pay, in contrast to the American law reform, TCJA. Because high executive pay has been subject to significant public criticism, mainstream tax reforms have limited executive pay deductions worldwide.⁵

For instance, Von Ehrlich and Radulescu (2017) undertook the 2009 UK tax law reform, and Bornemann et al. (2023) considered the 2014 Austrian tax law reform. The 2017 Japanese legal reform was unique because it expanded tax deductions. In Japan, the stock options introduced by the 1997 amendment to commercial codes commenced with performance-related pay. A stock option is a contract that gives a manager the right to buy the underlying stocks at a predetermined price. If the stock price increases, the manager can buy shares and cash based on the difference between stock and exercise prices. However, stock options also have disadvantages. According to Brealey et al. (2014), managers whose pay depends on stock prices are tempted to withhold bad news or to manage their earnings. They are also tempted to postpone or cancel valuable investment projects if their earnings are depressed in the short term. Additionally, stock options can encourage excessive risk taking.

Following stock options, restricted stock was also considered performance-related pay. This trend was consistent with that observed in the USA (Bebchuk & Fried, 2006). Restricted stock was provided to managers before they began to work for a new employer. Transfer restrictions were eliminated by the end of their tenure. Generally, the number of shares removed depended on their performance. If the time restriction was extended to retirement, competent managers can avoid quitting early. Moreover, restricted stocks provided incentives to managers in case of a stock price decline because they do not have to take responsibility for a firm's stock price fall owing to the general market. Managers cannot sell restricted stocks if stock prices increased. However, restricted stock continues to provide managers with value and incentives. Gorry, Hassett, Hubbard, & Mathur (2017) investigated the factors influencing the choice of restricted stock for executive compensation in American firms. Consequently, more restricted stocks are granted in low-income tax-rate years to avoid the high current personal tax rates. Additionally, the number of restricted stocks increased as performance-related pay increased because the \$1 million limit applied to non-performance-based pay (Section 162 (m)).

Trust shares have recently attracted increasing attention. The scheme was as follows: A company puts money to buy its own shares in a trust bank and sets a trust. The trust buys shares in the market. Finally, the company gives executive points depending on performance, such as sales and operating profits, and the trust gives shares as executive pay to executives, depending on these points. Trust shares provide executives with the full value of shares compared to normal stock options. Therefore, executives have incentives to increase firm value even when stock prices decrease. Furthermore, a company can set flexible incentive levels to increase firm value, because it can elastically decide how many points it gives executives, depending on the level of goal achievement. Restricted stocks and trust shares have disadvantages. Giving real shares does not prevent unsystematic risk because executives' portfolios are inclined toward their companies' shares, and their business judgement is likely to be conservative (Bagnani et al., 1994; Misumi et al., 2020). In addition, the common problem regarding the three types of performance-based pay is that

⁵ However, all the executive pay in listed firms is deductible in Japanese practices according to an ex regional taxation commissioner (*Asahi Newspaper, Morning edition*, November 2, 2014).

managers may exert less effort than shareholders expect, because they receive only part of the full firm performance they gain.

2.2 Effect of Deductibility on Executive Compensation

This section examines corporate taxes' theoretical influence on executive compensation. Executive compensation is a tax-deductible operating expense that reduces a firm's tax burden. Compensation is determined by internal considerations that mitigate the agency problem and supply and demand in the market for high-skilled executive labour. According to Bornemann et al. (2023), two theories predict the effects of deductibility expansion on executive compensation. First, according to the "efficient contracting" theory, the substantial decrease in compensation costs determine a new firm-internal optimum based on the after-tax costs relative to the benefits for shareholders in the effort generated by the manager. As after-tax costs significantly decrease, firms are expected to strive for higher executive compensation. However, executive compensation can remain unchanged depending on the executive's market power relative to the firm's market power in the labour market. The "rent extraction" view implies that managers extract rents beyond an optimal level. Therefore, contracts between managers and shareholders may be inefficient in the first place. Therefore, executive compensation increases after the introduction of tax deductibility expansion.

These arguments led to the following hypotheses.

H1: The market welcomes the expansion of performance-related pay.

H2: Japanese firms have adopted performance-related pay because of the 2017 corporate tax law reforms.

H3: Executive compensation has increased after the 2017 tax law reform.

3. METHODOLOGY

3.1 Data

This analysis ensured symmetrical pre- and post-revision periods. The dataset comprised approximately 13,000 firm-year observations of listed Japanese firms from 2015 to 2018.⁶ Financial firms were excluded because of their comparability to firms in other sectors. Financial data were sourced from the Nikkei NEEDS-CGES, and family firm data were manually collected from the 2018 edition of the Family Business White Paper published by Hakuto Shobou. Unconsolidated accounting data were used for firms that lack consolidated financial statements. To mitigate the effect of outliers, the data were winsorised at the 1st and 99th percentiles for each variable, excluding the indicator variables. Table 1 presents the variables used in this study.

⁶ In Japan, Cabinet Office Order on Disclosure of Corporate Affairs was revised in 2019, requiring Japanese firms to disclose information about executive compensation through their annual securities reports. This revision requires them to disclose information about performance-related executive pay, executive pay details depending on job positions, and executive pay amounts to promote constructive communications with investors.

Table 1. Description Of Study Variables

Variables	Descriptions
<i>Aveq</i>	The market value of equity plus total liabilities, deflated by total assets
<i>Cgper</i>	Indicator variable that takes one if a firm uses performance -related executive pay
<i>Lnpay</i>	Natural logarithm of executives' total pay
<i>Treat</i>	Indicator variable assigned a value of one if a firm is not a family firm before 2017
<i>After</i>	Indicator variable that equals one for the following post-policy change time period (2018) and zero otherwise
<i>Lnsls</i>	The natural log of total sales
<i>Vol</i>	Three-year standard deviation of market returns
<i>Roa</i>	Income before extraordinary items and taxes, scaled by total assets
<i>Fcfass</i>	Operating cash flows minus capital expenditures deflated by total assets
<i>Dass</i>	Total debt deflated by total assets
<i>Sfnd</i>	Current assets minus current debt, deflated by sales
<i>Idout_rto</i>	The percentage of independent outside directors on the board of directors

Source: Author (2026)

Law revisions apply to all Japanese firms. Therefore, it was difficult to select a suitable control group to isolate the deterrent effects of other concurrent events. We addressed this issue by focusing on the fact that performance-related pay deductions do not apply to family firms.⁷ The 2017 corporate tax law reform was enacted on 1 April 2017. This identification strategy led to the use of *Treat*, an indicator variable assigned the value of one if a firm was not a family firm before 2017 and zero otherwise. Family firms served as controls. *After* was another indicator variable set to one for the post-revision period (2018). For the dependent variables, I used Tobin's Q (*Aveq*), a dummy variable that took one if a firm used performance-related executive pay (*Cgper*),⁸ and the natural logarithm of executives' total pay (*Lnpay*). The analysis employed a difference-in-differences (DID) model with fixed effects using panel data. The sample used in this study comprised unbalanced panel data. The variable of interest was the interaction term *Treat*After*. The coefficient of *Treat*After* captures the difference between the change in the treatment and control groups before and after the law revision.

⁷ The 2018 edition of the Family Business White Paper designates a family firm as a firm where at least two family members serve as an executive or a shareholder. Consequently, this definition of family firm is slightly different from that of the corporate tax law. However, this study's control group is appropriate because it is unlikely to be affected by the law revision.

⁸ This study does not use a probit model because it may be difficult to interpret the coefficients while analyzing the model, including the interaction term, as the probit model applies the maximum likelihood method (Ai & Norton, 2003).

$$Aveq_{i,t+1} \text{ or } Cgper_{i,t+1} \text{ or } Lnpay_{i,t+1} = \alpha_0 + \alpha_1 Treat_i \times After_t + \sum \alpha_k Controls_{k,i,t} + \tau_t + \delta_i + \varepsilon_{i,t}$$

where i , t , and k represented the index firm, year, and control variables, respectively. τ and δ denoted year- and firm-fixed effects, respectively. ε is the error term. I control for year- and firm-fixed effects. Therefore, I excluded *Treat* and *After* because the coefficients of *Treat* and *After* are not estimated in this model (Blankespoor, 2019). The following control variables were used: business complexity (*Lnsls*, *Dass*, and *Sfnd*), degree of agency problems (*Fcfass*), information asymmetry regarding a firm's business (*Roa* and *Vol*), and board independence (*Idout_rto*). Table 2 presents the descriptive statistics. The number of *Lnpay* was relatively small because it was based on voluntary disclosure. Table 3 provides Spearman's and Pearson's correlation matrices for the control variables.

Table 2. Descriptive Statistics

Variables	N	Mean	Minimum	0.25	0.5	0.75	Maximum	St. Dev.
<i>Aveq_{i,t}</i>	13204	1.480	0.461	0.853	1.054	1.535	8.792	1.276
<i>Cgper_{i,t}</i>	13226	0.346	0.000	0.000	0.000	1.000	1.000	0.476
<i>Lnpay_{i,t}</i>	2188	4.983	2.860	4.369	4.949	5.583	7.678	0.869
<i>Treat_{i,t}</i>	13305	0.462	0.000	0.000	0.000	1.000	1.000	0.499
<i>After_{i,t}</i>	13305	0.500	0.000	0.000	0.000	1.000	1.000	0.500
<i>Lnslsi_{i,t}</i>	13290	10.433	6.513	9.189	10.321	11.569	15.048	1.775
<i>Voli_{i,t}</i>	12750	2.269	0.759	1.628	2.050	2.712	5.261	0.930
<i>Roai_{i,t}</i>	13181	6.382	-23.260	2.856	5.549	9.233	32.645	7.403
<i>Fcfassi_{i,t}</i>	13272	1.990	-369.587	-1.137	2.559	6.127	5600.000	50.296
<i>Dassi_{i,t}</i>	13298	45.868	8.000	30.400	45.600	60.400	88.800	19.522
<i>Sfndi_{i,t}</i>	13303	1.352	0.012	0.194	2.205	2.205	2.205	0.990
<i>Idout_rtoi_{i,t}</i>	12969	33.444	0.000	20.000	28.600	60.000	60.000	18.354

Table 3. Spearman's/Pearson's Correlation Matrix

	Lnslsi,t	Voli,t	Roai,t	Fcfassi,t	Dassi,t	Sfndi,t	Idout_rtoi,t
Lnslsi,t	1.00	-0.35	0.10	0.02	0.20	-0.27	0.16
Voli,t	-0.43	1.00	0.03	-0.03	0.08	0.21	-0.12
Roai,t	0.08	-0.07	1.00	0.38	-0.30	0.13	-0.05
Fcfassi,t	0.01	-0.15	0.06	1.00	-0.19	0.06	-0.02
Dassi,t	0.22	0.07	-0.24	-0.05	1.00	-0.19	0.04
Sfndi,t	-0.24	0.20	0.09	0.00	-0.14	1.00	-0.42
Idout_rtoi,t	0.16	-0.14	-0.03	0.01	0.05	-0.49	1.00

4. RESULTS AND DISCUSSION

The results are summarised in Table 4. The variable of interest *Treat*After* was significantly positive at the 1% level when the dependent variable was *Cgper*. The number of firms accepting performance-related executive pay had increased because of the 2017 corporate tax law reforms. *Treat*After* was not significant when the dependent variables were *Aveq* and *Lnpay*. This implied that the more performance-based pay systems firms adopted, the fewer fixed-pay systems they adopted. This was in line with the 2018 survey conducted by Deloitte Tohmatsu Consulting, LLC. Executives' total pay may not be significant because of increased financial reporting costs. Companies must disclose the calculation methods in their securities reports to implement tax deductions. They must disclose individual executive compensation amounts so that they can refrain from increasing compensation to distract public attention.

Table 4. Study Results in the Baseline Models

Variable	<i>Aveqi,t+1</i>			<i>Cgperi,t+1</i>			<i>Lnpayi,t+1</i>		
	Coef.	t-value	p-value	Coef.	t-value	p-value	Coef.	t-value	p-value
<i>Treati*Aftert</i>	-0.005	-0.274	0.784	0.029	2.592	0.010	0.011	0.437	0.662
<i>Lnslsi,t</i>	-0.390	-5.278	0.000	-0.004	-0.197	0.844	0.132	2.101	0.036
<i>Voli,t</i>	0.126	5.996	0.000	0.001	0.158	0.874	0.003	0.159	0.874
<i>Roai,t</i>	0.009	2.686	0.007	0.002	1.960	0.050	0.006	2.305	0.021
<i>Fcfassi,t</i>	0.003	3.492	0.000	0.000	-0.224	0.823	-0.002	-2.107	0.035
<i>Dassi,t</i>	0.004	1.573	0.116	0.000	-0.220	0.826	-0.002	-0.972	0.331
<i>Sfndi,t</i>	0.012	0.061	0.951	0.057	1.875	0.061	0.110	1.166	0.244
<i>Idout_rtoi,t</i>	-0.002	-1.768	0.077	0.001	1.204	0.229	-0.004	-1.517	0.130
<i>const</i>	5.043	5.729	0.000	0.238	1.151	0.250	3.693	5.587	0.000
<i>Year</i>	Yes			Yes			Yes		
<i>N</i>	12267			12315			1850		
<i>Within R-squared</i>	0.062866458			0.053306517			0.050544782		

Robust Standard errors for cluster structures are used to calculate t-values.

4.1 Additional Tests Diagrams

In the difference-in-differences approach, it was important to consider whether the proportion of *Cgper* in the treatment and control group firms follows similar trends before treatment; that is, whether the parallel trend assumption holds. To address this, the average number of dependent variables in the control and treatment groups were plotted according to the timeline.⁹ Figure 1 shows the results, indicating that parallel trends were observed before 2017.

⁹ *Cgper* data are unavailable in the database before 2014.

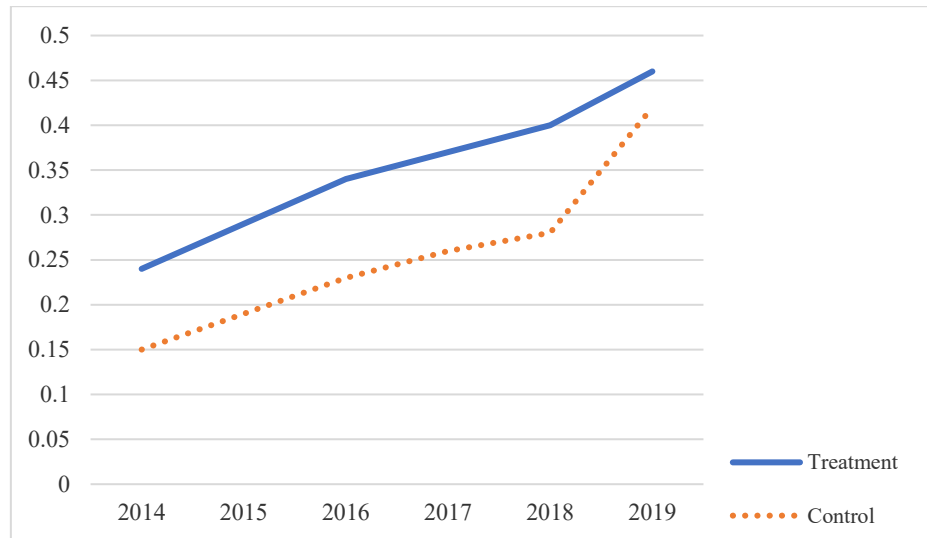


Fig. 1. Time-series Trend of The Average Number of *Cgper* for The Years 2014–2019

In addition, an event study model was employed by plotting regression coefficients with 95% confidence intervals for the treatment leads and lags, based on the work of Miller et al. (2021). The results as shown in Figure 2 indicated that the point estimates were nearly zero before the treatment.

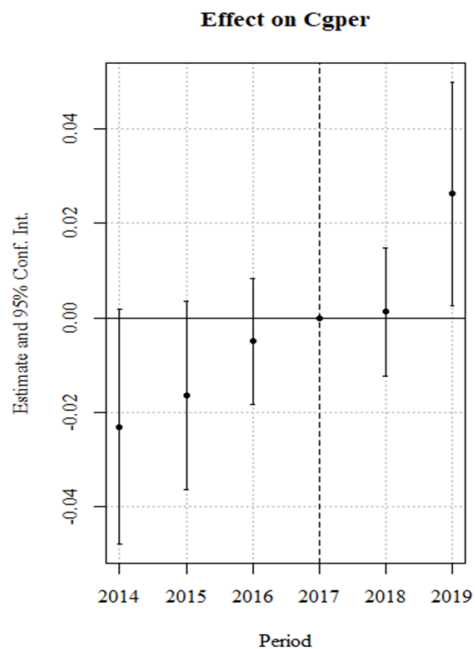


Fig. 2. Regression Analysis of *Cgper* at the 95% CI

5. CONCLUSION

This study used the 2017 corporate tax law reform to expand the definition of deductible performance-based pay as an exogenous shock. The number of firms accepting performance-related executive pay had increased because of the 2017 corporate tax law reforms. However, no evidence existed regarding investors welcoming reforms or increases in executive compensation. This can be explained by the efficient contracting theory.

This study contributes to existing literature in several ways. First, it adds to the literature on corporate taxes and executive compensation (Bird, 2018; Bornemann et al., 2023; Von Ehrlich & Radulescu, 2017) by focusing on Japanese events. The 2017 Japanese legal reform was unique because it expanded tax deductions for executive compensation. Second, this study elucidated the effects of the revision on corporate behaviour in corporate governance literature (Bebchuk & Fried, 2006; Gong et al., 2025). Finally, this study provides practical implications for Asian regulators and rule-making institutions where corporate governance is still developing. However, this study has some limitations. Future studies should investigate the effects of various performance-related executive pay schemes. This revision values shareholders and is questionable considering the tax philosophy, which calls for fair sharing of tax burdens. Future studies should investigate the theoretical validity of the reform.

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7. CONFLICT OF INTEREST STATEMENT

The author agrees that this research was conducted in the absence of any self-benefits, commercial or financial conflicts and declare the absence of conflicting interests with the funders.

8. AUTHORS' CONTRIBUTIONS

The author was solely responsible for all aspects of the study including Conceptualization; Methodology; Software; Validation; Formal analysis; Investigation; Resources; Data Curation; Writing - Original Draft; Writing - Review & Editing; Visualization; Supervision; Project administration; Funding acquisition.

9. DECLARATION OF GENERATIVE AI IN THE WRITING PROCESS

The author did not use generative AI or AI-assisted technologies in the writing process of this manuscript.

10. DATA AVAILABILITY/SUPPLEMENTARY MATERIALS

The data in this study were obtained from the Nikkei NEEDS-CGES and the 2018 edition of the Family Business White Paper published by Hakuto Shobou.

11. ETHICS STATEMENT

This study relies entirely on publicly available data and literature, and does not involve any new human or animal subjects. The author adheres to the highest standards of academic integrity, and no data fabrication, falsification, or plagiarism was committed.

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