SB 395

Department of Legislative Services
Maryland General Assembly
2007 Session

FISCAL AND POLICY NOTE

Senate Bill 395 (Senators Pinsky and Madaleno)
Budget and Taxation

Income Tax - Corporations - Denial of Deduction for Excessive Compensation of Officers and Directors

This bill requires a corporation to add back to its Maryland modified income, to the extent excluded from federal taxable income, the amount that the compensation of an officer or director exceeds 30 times the compensation of the lowest paid full-time employee.

The bill takes effect July 1, 2007, and applies to tax year 2007 and beyond.

Fiscal Summary

State Effect: Potential minimal increase in general fund and Transportation Trust Fund revenues in FY 2008 and beyond. General fund expenditures would increase by $34,000 in FY 2008 due to one-time tax form and computer programming expenses at the Comptroller's Office.

(in dollars)	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenue	-	-	-	-	-
SF Revenue	-	-	-	-	-
GF Expenditure	34,000	0	0	0	0
Net Effect	($34,000)	$0	$0	$0	$0

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Potential minimal increase in local highway user revenues. No effect on expenditures.

Small Business Effect: Minimal.

Analysis

Current Law: No similar addition modification under the Maryland income tax exists. Under federal law, certain amounts of compensation paid to employees are deductible as discussed below. These deductions can typically flow through to the corporation's Maryland modified income.

Background: Under Section 162 of the Internal Revenue Code, businesses can deduct as an ordinary and necessary business expense a reasonable allowance for salaries and compensation paid to its employees. Since 1994, publicly held corporations required to be registered under Section 12 of the Securities and Exchange Law of 1934 may not deduct more than $1 million in annual compensation to a chief executive officer (CEO) or to the four highest compensated officers. The limit does not apply to: • commissions paid solely based on income generated by individual performance of the director or officer; • retirement plan contributions; • benefits such as health care that would typically be excluded from adjusted gross income; • pay under a binding contract in effect as of February 17, 1993; and • performance-based compensation. Performance-based compensation must meet the following criteria in order to be deductible:

- The compensation must be solely based on whether the executive attained one or more preestablished, objective performance goals.
- A compensation committee comprised solely of two or more outside directors establishes the performance goals.
- The terms of the performance goals must be disclosed to and approved by the corporation's shareholders.
- The compensation committee must certify in writing that the performance goals were met.

State Revenues: Corporate income tax revenues could increase minimally in fiscal 2008 and beyond due to the required add-back. Any increase is likely to be minimal due to the limited number of affected corporations and additional factors discussed below.

Legislative Services examined the executive compensation, as reported to the Securities and Exchange Commission, of 35 publicly traded corporations that are large employers in the State. Data on privately held corporations are unavailable. The median CEO salary of the publicly traded corporations was $3.3 million, and the median salary of the top four executives was $1.3 million. Based on the assumption that each of these corporations pays its lowest-paid full-time employee the State minimum wage plus health care and other fringe benefits, corporate income tax revenues would increase by a maximum of $300,000 from these corporations. This analysis also assumes that all the compensation is excludable from federal adjusted gross income and that the average apportionment factor of each corporation is 2%. The actual revenue gain, however, is likely to be minimal for several reasons. First, the compensation is for the executives of the parent corporation – a unit of the corporation with lower executive pay might be the actual State income tax filer. Second, two-thirds of all corporations typically do not have a State income tax liability. Corporations could continue to have zero tax liability regardless of the add-back. Third, affected corporations could employ tax strategies in response to the legislation.

State Expenditures: The Comptroller's Office reports that it would incur a one-time expenditure increase of $34,000 in fiscal 2008 to include the add-back with the corporate income tax form. This amount includes data processing changes to the SMART income tax return processing and imaging systems and systems testing.

Additional Information

Prior Introductions: Similar bills were introduced in 2002 and 1997. SB 879 of 2002 was withdrawn. SB 691 of 1997 received an unfavorable report from the Senate Budget and Taxation Committee.

Cross File: None.

Information Source(s): Comptroller's Office, Internal Revenue Service, Securities and Exchange Commission, Department of Legislative Services

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Analysis by: Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510