SB 472

Department of Legislative Services
Maryland General Assembly
2009 Session

FISCAL AND POLICY NOTE

Senate Bill 472 (Senator Pinsky, *et al.*)
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 25 times the compensation of the lowest paid full-time employee.

The bill takes effect July 1, 2008, and applies to tax year 2009 and beyond.

Fiscal Summary

State Effect: Potential minimal increase in general fund and Transportation Trust Fund revenues in FY 2010 and beyond. General fund expenditures increase by $37,400 in FY 2010 due to one-time tax form and computer programming expenses at the Comptroller's Office.

(in dollars)	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
GF Revenue	-	-	-	-	$0
SF Revenue	-	-	-	-	-
GF Expenditure	$37,400	$0	$0	$0	$0
Net Effect	($37,400)	$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. Local expenditures are not affected.

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 (IRC), 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: (1) commissions paid solely based on income generated by individual performance of the director or officer; (2) retirement plan contributions; (3) benefits such as health care that would typically be excluded from adjusted gross income; (4) pay under a binding contract in effect as of February 17, 1993; and (5) 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.

The federal Emergency Economic Stabilization Act (EESA) of 2008, enacted October 3, 2008, authorized the Secretary of the Treasury to establish a Troubled Assets Relief Program (TARP) intended to provide financial assistance to the struggling banking industry. EESA includes two sections that address executive compensation rules. EESA generally reduces the $1 million annual compensation limit to $500,000 for compensation to certain executives and eliminates the existing exception for performance-based compensation and certain other exceptions for these executives. These limitations apply to a financial institution (including privately-held and noncorporate entities) that during the tax year receives specified financial assistance under TARP.

Under Section 280G of the IRC, certain payments in excess of specified limits, referred to as "excess parachute payments" are not deductible by a corporation. Section 4999 imposes an excise tax on the recipient of any excess parachute payment equal to 20% of the payment. EESA expands the definition of parachute payment to include certain severance payments made to a covered executive of an institution participating in TARP.

State Revenues: Corporate income tax revenues may increase minimally in fiscal 2010 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 25 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 $10 million. Based on the assumption that each of these corporations pays its lowest-paid full-time employee the federal minimum wage plus health care and other fringe benefits, corporate income tax revenues would increase by a maximum of $350,000 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 1%.

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. Lastly, executive compensation is likely to be lower at least during the near-term as a result of EESA limitations and the recent overall decrease in CEO compensation due to the depressed corporate earnings. According to Forbes, average U.S. CEO compensation decreased from $15.6 million in 2007 to $12.8 million in 2008.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $37,400 in fiscal 2010 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: SB 395 of 2007 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. 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, Securities and Exchange Commission, Department of Legislative Services

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