

**PROPOSAL TO LIMIT DEDUCTION FOR EXECUTIVE COMPENSATION**

(Scheduled for a Hearing Before the Senate Finance  
Subcommittee on Taxation on June 4, 1992)

**I. Present Law**

Under present law, a deduction is allowed in computing Federal income tax liability for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

**II. Description of Proposal**

**Background**

The provision described below limiting the deduction for executive compensation has been included in the following bills that recently have been passed by the Congress or reported by committee.

The conference report on H.R. 4210 ("Tax Fairness and Economic Growth Act of 1992") was passed by the House and the Senate on March 20, 1992 (see H. Rept. 102-461), and was vetoed by the President on that date. H.R. 4727 was reported by the House Committee on Ways and Means on May 27, 1992 (H. Rept. 102-536, Part 1), and H.R. 5260 was reported by the House Committee on Ways and Means on June 2, 1992 (H. Rept. 102-543, Part 1). H.R. 4727 and H.R. 5260 provide an extension and revision of Federal unemployment compensation benefits.

**Explanation of Provision**

For purposes of the regular income tax and the alternative minimum tax, the otherwise allowable deduction for compensation with respect to a covered employee is limited to no more than \$1 million per year. A covered employee means any employee of the taxpayer who is an officer of the taxpayer, other than an employee-owner of a personal service corporation.

For purposes of the provision, whether an individual is an officer is determined upon the basis of all the facts, including, for example, the source of his or her authority,

the term for which elected or appointed, and the nature or extent of his or her duties. Generally, an officer is an administrative executive who is in regular and continued service, regardless of the employee's job title. An employee who has the title of an officer but does not have the authority of an officer is not considered an officer. Similarly, an employee who does not have the title of an officer but has the authority of an officer is an officer for purposes of this rule.

An employee-owner of a personal service corporation is generally defined as under section 269A of the Code. Thus, a personal service corporation is a corporation the principal activity of which is the performance of personal services if the services are substantially performed by employee-owners. An employee-owner is any employee who owns more than 10 percent of the outstanding stock of the personal service corporation.

The provision applies only to compensation of employees who are officers (or, in the case of former employees, who were officers at any time while active employees). The provision does not apply to payments to partners in a partnership because they are not employees. The provision also does not apply to payments to independent contractors.

The term covered employee includes former employees. Thus, for example, the provision applies to compensation of a former employee for services performed as an employee (e.g., nonqualified deferred compensation that is not received until after termination of employment).

The deduction limitation generally applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. The limit does not apply to fringe benefits excludable from income under section 132, meals and lodging furnished on the business premises of the employer that are excludable under section 119, or any payment made to, or on behalf of, an employee or beneficiary (1) from or to a qualified pension, profit-sharing, or annuity plan, or (2) under a simplified employee pension (SEP) or tax-sheltered annuity (other than elective deferrals to such a plan or annuity). The deduction limitation applies to all compensation paid to a covered employee, regardless of whether the compensation is paid for services as an officer.

The deduction limitation applies at the time the deduction would otherwise be taken by the employer, whether or not the remuneration to which the deduction relates is for service performed during the taxable year.

Certain related employers are treated as a single employer for purposes of the provision. In particular,

employers treated as a single employer under section 52(a) or (b) or section 414(m) or (n) are treated as a single employer. An employee who is an officer of any of the members of a group of employers treated as a single employer is treated as an officer of the single employer. Similarly, compensation from related employers is aggregated for purposes of the \$1 million limit.

The report language on the H.R. 4210 conference agreement, H.R. 4727, and H.R. 5260 indicates that it is intended that the Secretary will prevent avoidance of the rule through the use of arrangements other than employee-employer arrangements or through other means.

#### Effective Dates

The provision in H.R. 4210 would be effective for taxable years beginning after December 31, 1991.

The provision in H.R. 4727 would be effective for amounts paid or accrued on or after July 1, 1992.

The provision in H.R. 5260 would be effective for taxable years beginning on or after January 1, 1992.