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External Multistate Tax Alert
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State income tax considerations associated with business interest expense limitations, IRC Section 163(j) and Notice 2018-28

Overview

On December 22, 2017, P.L. 115-97 (the Act) was signed into law. Among other changes, the Act replaces current IRC section 163(j) with a new rule that potentially limits the deduction for business interest expense. On April 2, 2018, the Internal Revenue Service issued guidance with respect to the new business interest expense limitations. See Notice 2018-28 (the Notice) available here.

This tax alert highlights various state income tax considerations related to the business interest expense limitations of IRC section 163(j) as well as the guidance provided by the IRS in the Notice.

Business Interest Expense Limitation, in General

Subject to certain limitations, business interest may generally be deducted. Effective for tax years beginning after December 31, 2017, Section 13301(a) of the Act replaces current section 163(j) with a new rule that applies to every business – regardless of its form – and disallows the deduction for net business interest expense in excess of 30 percent of the business's "adjusted taxable income" plus business interest income and floor plan financing interest. "Adjusted taxable income" is defined as the taxable income of the taxpayer computed without regard to (i) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business, (ii) any business interest or business interest income, (iii) the amount of any net operating loss deduction under section 172, (iv) the amount of any deduction allowed under section 199A, and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. Business interest that is not otherwise allowed as a deduction by reason of new section 163(j) would be treated as paid or accrued in the succeeding taxable year and can be carried forward indefinitely.

The Notice issued on April 2 announced the intent of Treasury and the IRS to issue proposed regulations under section 163(j) that are anticipated to address certain technical issues arising under new section 163(j). Before issuance of regulations, taxpayers may rely on the rules described in Sections 3-7 of the Notice.

State Income Tax Considerations

New section 163(j) creates additional complexity for taxpayers in determining their state income tax liabilities. As set forth in Section 5 of the Notice, it is anticipated that to-be-issued temporary regulations will, consistent with the legislative history, clarify that the limitation under new section 163(j) applies at the consolidated group level, and that the regulations will not include a general rule treating an affiliated group that does not file a consolidated return as a single taxpayer for purposes of new section 163(j).

Implications will vary based on filing methodology applicable in state. The clarifications in the Notice will likely have a direct impact in determining the new section 163(j) limit in state tax jurisdictions which require entities to file separate income tax returns. Where a jurisdiction requires federal taxable income to be determined as if a separate federal return had been filed, it is anticipated that the new section 163(j) limitation will be computed on a separate company basis. This obviously has the potential to result in different federal and state section 163(j) limitations that, depending on the facts, may allow more or less business interest to be deducted for state income tax purposes in a given tax year. A similar separate company calculation may also be required in jurisdictions that require combined reporting but do not conform to the applicable federal consolidated return regulations. Finally, even in combined reporting jurisdictions that do conform to the applicable federal consolidated return regulations, a unique state section 163(j) calculation may be required if the entities included in the state combined filing group do not conform with the entities included in the federal consolidated filing group.

The Notice indicates that forthcoming regulations will provide for the allocation of the business interest expense limitation among group members. A similar allocation may be necessary in certain combined return state tax calculations where taxable income or loss must be determined for each member of the group to determine state tax attributes (e.g., net operating losses) or the allowance of state tax attributes such as net operating loss carryovers or tax credits.

Related-party addback rule implications – in general. In addition to considering whether a separate state section 163(j) limitation is necessary, taxpayers must also determine the impact of state related-party interest addback ("related-party addback") rules. Whereas new section 163(j) rules provide for a potential deferral and carryover of business interest expense, related-party addbacks may result in a permanent disallowance of some or all interest paid to related parties. Although the Notice indicates that intercompany obligations may be eliminated between consolidated group members, this rule is unlikely to apply in separate return jurisdictions.

In addition, the Notice is silent as to whether forthcoming regulations will provide guidance as to how to allocate a section 163(j) limitation between multiple sources of interest expense (e.g., allocate the 163(j) limitation between interest paid to a related party verses a third-party). While there may not be a reason to do this type of allocation for federal tax purposes, taxpayers may need to make reasonable assumptions about how to make such an allocation until affected states provide additional guidance.

Furthermore, while the application of related-party addback rules may apply to the business interest actually deducted in a tax year (i.e., after the new section 163(j) rules are applied), the safe-harbor exceptions to such related-party addbacks may produce unexpected results when business interest is allowed as a deduction under new section 163(j) for federal purposes in a year subsequent to the year it was actually incurred.

Related-party addback rule implications – Maryland example. Maryland's related-party add back pertains to otherwise deductible interest expense paid to a related party. Interest expense for this purpose is defined as the amount allowed as a deduction under Section 163 of the Internal Revenue Code for purposes of determining taxable income. Accordingly, the Maryland related-party addback would apply to the amount of interest expense allowed after the imposition of section 163(j) for a given year. Maryland's so-called conduit safe harbor exception provides an exception to the add-back where the interest expense was paid pursuant to arm's-length contracts at an arm's-length rate and where during the same taxable year, the related member paid the interest expense to a person who is not a related member. Under this rule, if related-party interest expense that would otherwise meet the conduit exception in Year 1 was, for example, deferred under section 163(j) and deducted in Year 3, it is not clear that it would meet the conduit exception as the related party likely paid the unrelated person in Year 1 (i.e., in the year when the interest expense was originally paid but deferred under section 163(j)). Because the related-party add-back rules were enacted before the new section 163(j) deferral rule was enacted, there may be unintended consequences. Similar considerations and consequences may exist in other states as well.

Considerations

Taxpayers are advised to model section 163(j) limitations on a state-by-state basis in order to determine the potential impact of the Act on business interest expense in taxable years beginning after December 31, 2017. Taxpayers should also consider the impact of related party debt and the application of state related party addback rules and safe harbors in light of section 163(j). Application of section 163(j) on a separate company basis may also impact assumptions regarding the utilization of tax attributes such as NOL or credit carryovers. Finally, consideration may also be appropriate for debt placement and organizational restructuring options that may enhance the value of interest deductions.

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