State & Local Tax Advisory

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# State Guidance Needed After Treasury Issues Proposed Regulations Under Section 163(j)

On November 26, the Department of the Treasury issued proposed regulations concerning the new interest expense limitation under Section 163(j) that was enacted last year through the Tax Cuts and Jobs Act. While the regulations address many issues related to how the limitation applies in computing federal income tax, questions remain on how to apply the new Section 163(j) for state tax purposes.

Currently, about half the states follow the new Section 163(j), either through rolling conformity or by adopting a post-Act conformity date. Several other states, including Georgia, have enacted legislation that specifically decouples from the federal limits under Section 163(j).

Section 163(j) limits business interest expense deductions to the taxpayer's business interest income, plus 30% of its adjusted taxable income, and its floor plan financing interest. One big question that was answered through the proposed regulations is that, for commonly owned corporations that file a consolidated federal income tax return, the interest expense limitation is determined on a consolidated basis and allocated to individual group members according to the percentage of consolidated interest allowed and applying it to each individual member's business interest expense.

Applying Section 163(j) on a consolidated basis at the federal level creates significant complexities for computing allowable interest expense at the state level. For example, in states that require commonly owned corporations to report income on a separate-company basis, the allowable business interest expense for individual entities of the federal consolidated group could be reduced, increased, or eliminated. Similarly, based on the mechanics of computing the limitation on a separate-entity basis, the aggregate allowable interest expense of all entities that are included in the federal consolidated return could be significantly less than the amount available at the federal level.

In addition, because the allowable interest expense deduction is determined on a consolidated basis at the federal level, it generally will not matter which specific entity in the consolidated group had interest expense or income. However, in states that require separate company reporting, there is no mechanism for related entities to share interest expense, and thus there is risk that interest expense may never be utilized depending on which entities of the affiliated group generate the interest income and expense. Similarly, separate reporting states that both conform to the new Section 163(j) limitation and that disallow an expense deduction for interest paid to affiliates (i.e., an "interest addback") will need to address the potential for double taxation. For example, if the interest income is subject to tax in the hands of the affiliate-payee, then the payor would typically not be required to add back the expense deduction in computing its separate company income. However, to the extent that the interest expense is limited at the federal level and the state conforms to the new Section 163(j), then the payor and payee could both pay tax on the same value.

Computational issues will likely also arise in states that require or permit commonly owned corporations to report income on a combined or consolidated basis. Based on state law and constitutional restrictions, the composition of the state combined reporting group may vary significantly from the composition of the federal consolidated group and will often vary even among states that have similar combined return reporting requirements. Moreover, even where the composition of the state and federal consolidated group is the same, the computation of combined group income at the state level may be determined on a separate-entity basis and/or may not conform, or only partially conform, to the federal consolidated return regulations. Taxpayers will need to independently consider each state's rules for computing the allowable interest expense.

Although these issues are sure to create state tax compliance headaches, they are only a small sample of the potential complexities flowing from the new federal interest expense limitation under Section 163(j) and the 439 pages of the proposed regulation package released by Treasury. We will monitor developments on the proposed regulations and the states' reactions to them and provide additional commentary throughout the process.

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