Federal Tax Reform – Impact on 2019 Legislative Sessions: Overview of IRC 163(j)

Executive Committee Task Force on State and Local Taxation
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Overview of 163(j)

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IRC 163(j) – limiting deductibility of interest expense

- Business interest expense deduction limited to 30% of a taxpayer's "adjusted taxable income" (ATI).
  - Mimics the EBITDA accounting term (i.e. earnings before interest, taxes, depreciation and amortization)
  - Depreciation and amortization added back to ATI after January 1, 2023
- The federal limitation will be determined at a taxpayer's federal consolidated group level.
- Any disallowed interest expense can be carried forward indefinitely.
- Exceptions:
  - The limitation does not apply to businesses with less than $25 million gross receipts.
  - Specific industries are exempt like publicly regulated utilities, real estate, farming and agricultural co-ops.
  - If exempt, then you lose federal bonus depreciation.

Why was interest expense deductibility limited?

- Congress limited it to pay for a 40 percent corporate income tax rate reduction and immediate expensing of qualified assets.
- This way, companies are incentivized to invest in new assets without over-relying on debt financing.
- However, most states decouple from federal bonus depreciation rules under IRC 168(k).
  - If these states conform to 163(j), companies would be denied immediate expensing on qualified assets and interest expense deductibility at the same time – two policies that disincentivize investment and growth.

This interest limitation without offsetting tax cuts is a significant corporate tax increase.

Table 2. Estimated change in the US federal corporate tax base due to the Tax Cuts and Jobs Act of 2017, by major provision (average percentage change in US economy-wide corporate tax base, 2018-2027; the percentage changes in each year will vary)

Business provision	% change in federal corporate tax base
One-time transition tax on un-repatriated foreign earnings	+9.0%
Net interest expense limitation (30% of ATI)	+6.4%
Modification of net operating loss deduction	+5.3%
Global intangible low-taxed income (GILTI) inclusion	+5.5%
Deduction for global intangible low-taxed income (GILTI)	(2.6%)
Amortization of research and experimental expenditures	+2.9%
Repeal of domestic production activities deduction	+1.9%
Limit deduction of fringe benefits	+0.7%
Limit like-kind exchanges of personal property	+0.5%
Base erosion anti-abuse tax (BEAT)*	0.0%
Increased expensing under Section 179	(0.3%)
Small business accounting method reform and simplification	(0.8%)
Foreign derived intangible income (FDII) deduction	(1.7%)
Expensing provided under Section 168(k) bonus depreciation	(1.8%)
Move to territorial system of taxation	(5.9%)
Total change in federal corporate taxable income from major provisions**	**+19.1%**

Source: Ernst & Young LLP analysis incorporating JCT revenue estimates

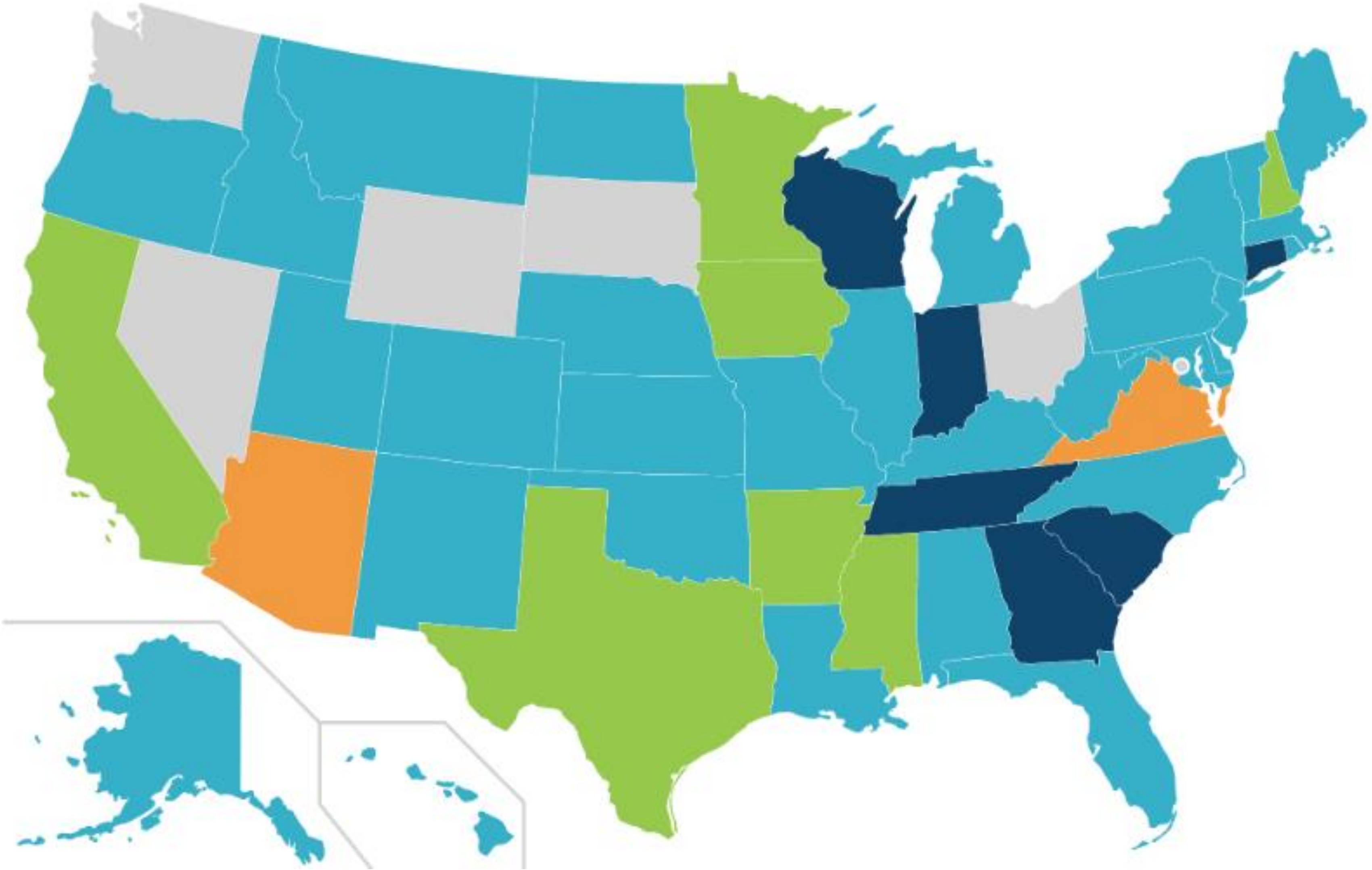
* BEAT is a minimum tax and does not impact the regular tax base

** Total reflects only major provisions shown in this table

Note: table does not sum due to rounding

Current status of 163(j) across the states

- Decouples from 163(j) through enacted legislation
- Conforms to 163(j) as of 1/1/18
- Does not adopt 163(j) as of 1/1/18
- For 2018 tax year – IRC adopted as of 1/1/2017, effectively decoupling from 163(j)



State Issues Relating to 163(j)

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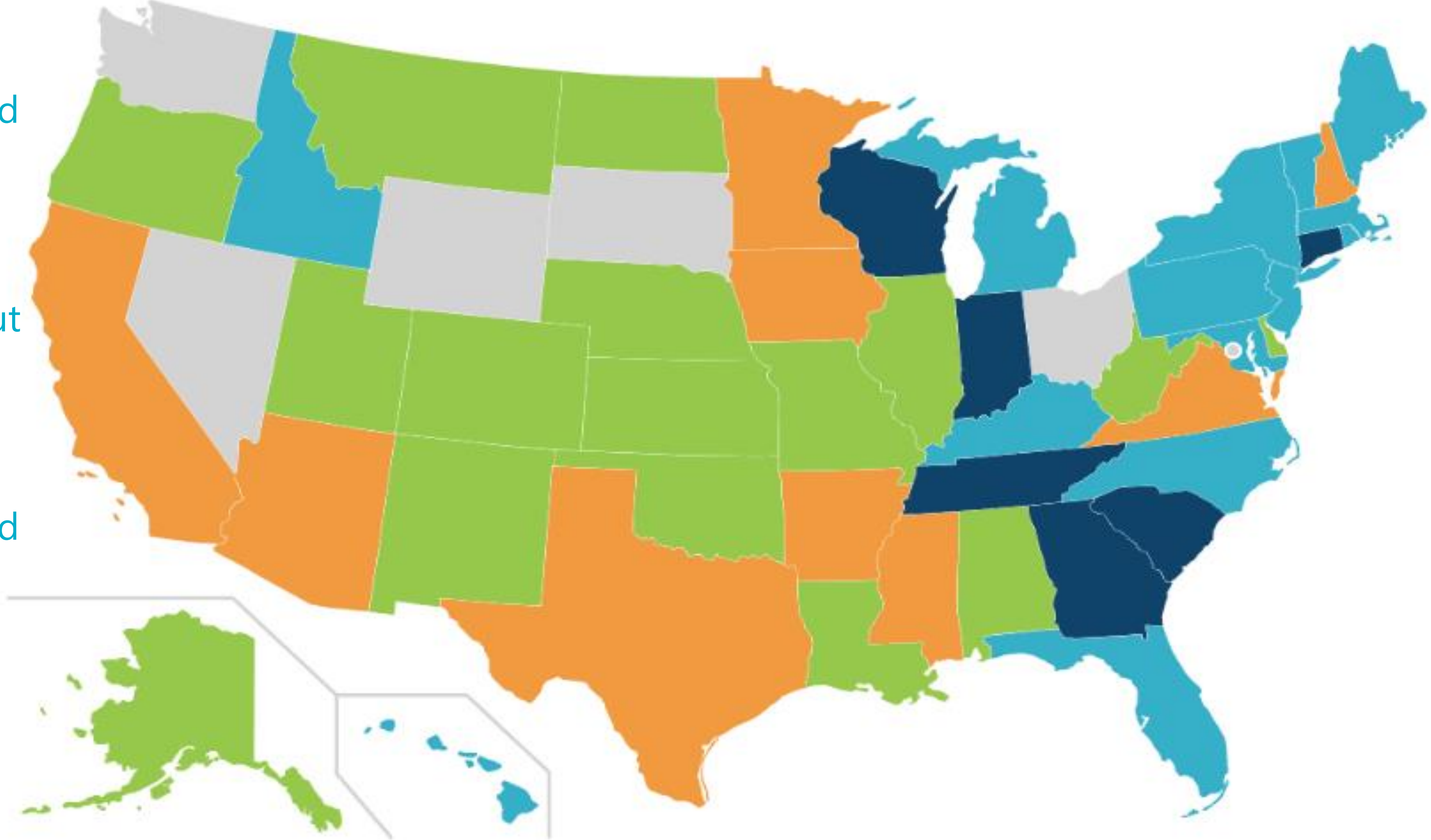
Does your state decouple from the new federal 100 percent expensing rules?

- Decouples from new 168(k) and has not adopted new 163(j) as of 1/1/18
- Decouples from new 168(k), but conforms to new 163(j) as of 1/1/18
- Decouples from new 168(k) and decouples from new 163(j) through enacted legislation
- Conforms to new 168(k) and conforms to new 163(j) as of 1/1/18



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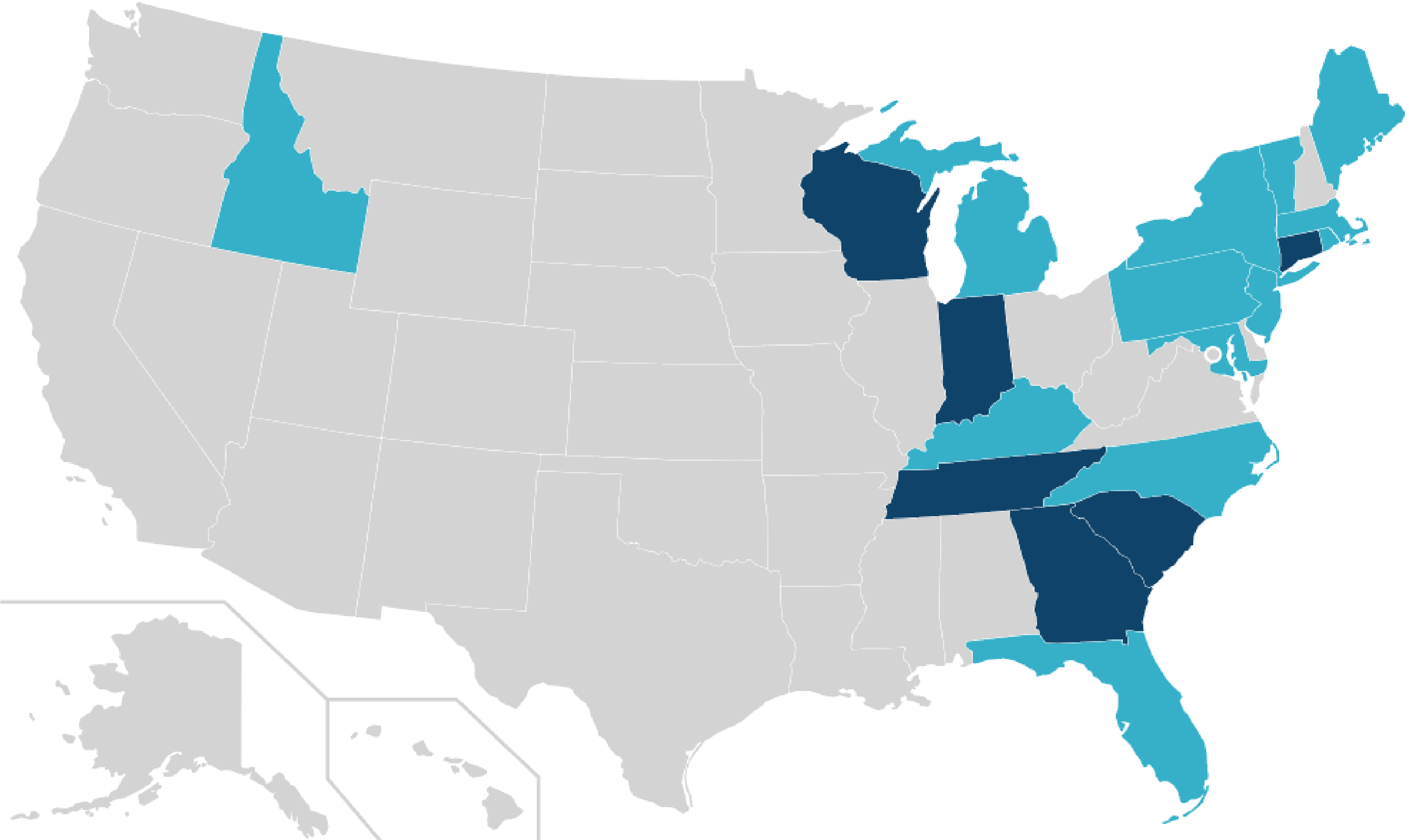
Does your state decouple from the new federal 100 percent expensing rules?

Decouples from 168(k) and conforms to 163(j) as of 1/1/18

Decouples from 168(k) and decouples from 163(j) through enacted legislation



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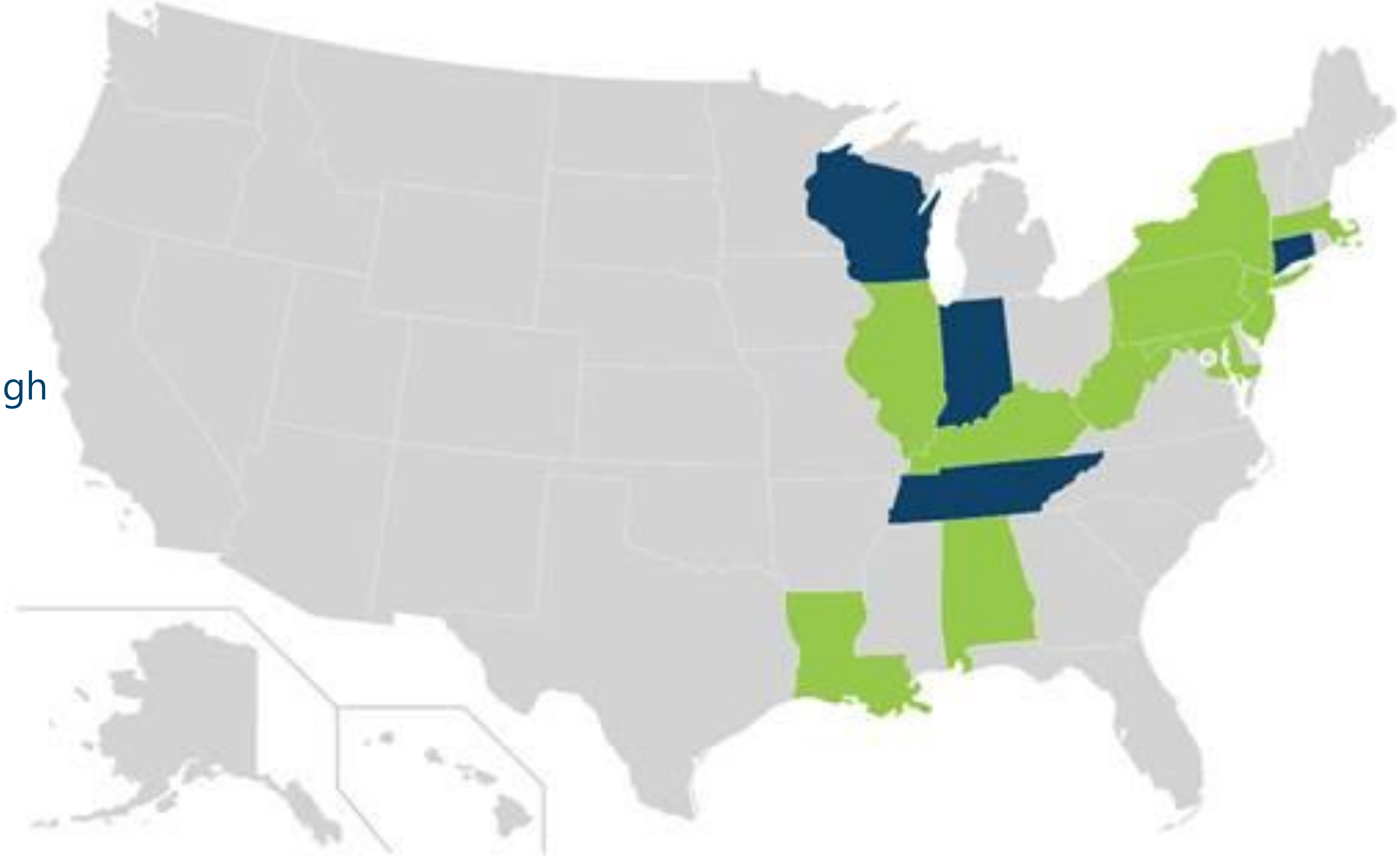
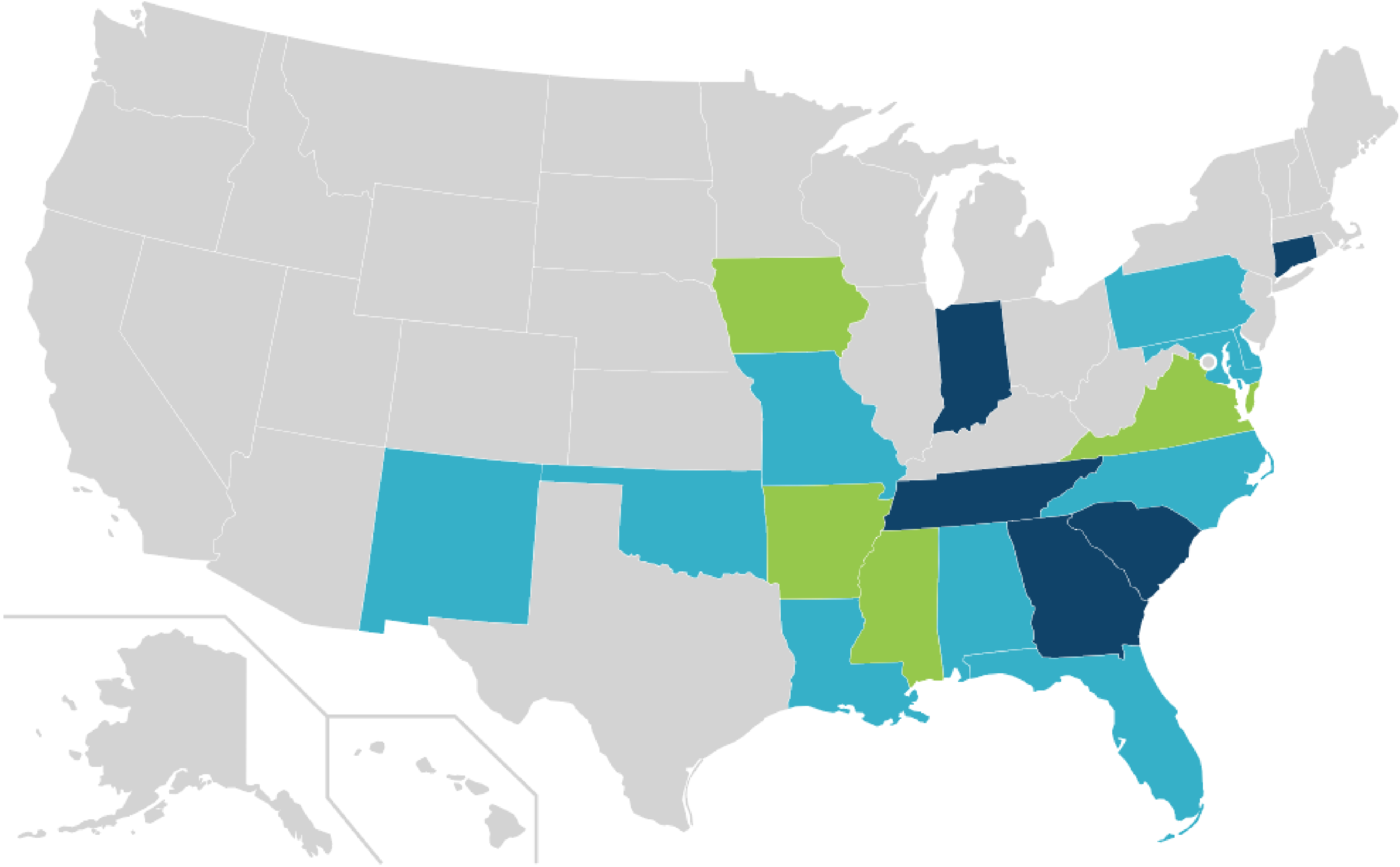
Does your state have an interest expense addback?

- Has an interest addback, but conforms to 163(j) as of 1/1/18
- Has an interest addback, but decouples from IRC 163(j) through legislation



Is your state a separate entity or combined return filing state?

- Separate return state and does not conform to IRC 163(j) as of 1/1/18
- Separate return state and conforms to IRC 163(j) as of 1/1/18
- Separate return state that decoupled from 163(j) through legislation



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Appendix: State Responses to 163(j)

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State responses to IRC 163(j)

Georgia HB 918, enacted March 2, conforms to IRC 163(j) as of December 21, 2017 — the day **before** the TCJA was enacted:

Wisconsin A.B.259, enacted April 3, conforms to Internal Revenue Code as of December 31, 2017 and decouples from numerous provisions of TCJA, including IRC 163(j).

Indiana HB 1316, enacted May 14, allows taxpayers to subtract from adjusted gross income any non-deductible interest expense, effectively decoupling from IRC 163(j).

Tennessee S.B. 2119, enacted May 21, decouples from IRC 163(j) for tax year 2020 and beyond.

Connecticut SB 11, enacted May 31, decouples from IRC 163(j).

South Carolina H.5341, enacted October 3, decouples from numerous provisions of TCJA, including IRC 163(j).

State responses to IRC 163(j)

New Jersey AB 4202, enacted July 1, 2018, conforms New Jersey corporation business tax (CBT) law to IRC 163(j) but requires that the section apply on a pro rata basis, including intercompany interest already required to be added back to entire net income.

The law provides no guidance as to what "pro rata" means or is intended to mean:

- Is it supposed to be applied on a federal affiliated group basis, on a New Jersey state filing group basis or is the limitation supposed to be allocated between the amounts subject to the related party addback requirement and all other interest paid?

- Is "pro rata" supposed to be on the amount of tax paid, on the amount of interest paid, or on the net worth of the related members?

Thank you!

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