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Interest Deduction Limitations Under Section 163(j): IRS Final Regs, State Tax Issues, Partnerships, CFC

Rules for Computing ATI, Determining Deduction Cap, Special Carryover and Transition Rules, Elections and Exemptions

TUESDAY, OCTOBER 26, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Smith Gambrell Russell

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October 26, 2021

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Interest Deduction Limitations Under IRC Section 163(j)

1. General Rules and Overview
2. Exemptions from the Rules
3. Rules for Pass-Through Entities
4. Structuring Within the Rules
5. Alternatives to Debt
   A. Lease Structures
   B. Installment Sales
   C. Partnership Preferred Equity

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1. General Rules and Overview

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Interest Expense Reform

- The Tax Cuts and Jobs Act of 2017 (the “TCJA”) changed the rules for interest expense deductions.
- Under prior law, a business could deduct interest expense, subject generally to accounting rules like OID.
- Starting with 2018, an additional limitation is added: net interest expense is generally deductible only to the extent it is equal to or less than the cap amount, as computed below.

Computation of the Cap

- Business interest expense is disallowed to the extent it exceeds the cap, which is the sum of:
  - business interest income plus
  - floor plan financing interest plus
  - the threshold amount
- Note that this computation effectively allows netting of business interest expense and business interest income.
- Also, this computation effectively exempts all floor plan financing interest (defined below).

Interest Expense Reform

- The threshold amount is 30% of the taxpayer's applicable taxable income (ATI).
- Generally ATI starts with taxable income, but is computed without regard to:
  - business interest income or expense
  - NOL deductions
  - income, gain, deduction, or loss which is not properly allocable to a trade or business, and
  - the 20% pass-through entity deduction

Interest Expense Reform

- Starting in 2022, this amount also excludes any deduction allowable for depreciation, amortization, or depletion.
- Note that as used in the base computation, the threshold amount is never less than zero.
- Key measures:
    - BIE = business interest expense
    - BII = business interest income
    - ATI = applicable taxable income

Interest Expense Reform – CARES Act

- The CARES Act significantly relaxed the interest cap rules, but this only applies for 2019 and 2020.
- Instead of the 30% limitation noted above, the cap is increased to 50% for these two years.

Interest Expense Reform – Proposals

- Note that certain changes to IRC 163(j) were contained in the House Ways and Means Committee proposal that was released on September 13, 2021.
- The House has proposed using IRC 163(j) to limit the deduction of interest expense by U.S. members of a multination group. The US members would be limited to a share of the group's total interest expense determined by dividing the U.S. members' EBITDA by the group's entire EBITDA.
- The 163(j) limitation as applied to partnerships and S corporations would also be revised by computing the limitation as the owner level, rather than at the entity level.
- Finally, disallowed interest expense could only be carried forward for 5 years, rather than indefinitely.

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Entity Based Caps

- Applies to all taxpayers, but there are specialized rules for interest incurred by C corporations, S corporations entities taxed as partnerships and CFCs.

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Interest Expense Reform

- No grandfathering of existing debt or transition period relief.
- There are several significant exceptions to the new cap:
  - businesses with annual gross receipts up to $25mm
  - real estate
  - farming
  - regulated utilities
  - floor financing plan interest

Interest Expense Reform

- The effect of this change is to defer, not re-characterize interest.
- Any disallowed interest expense carries forward indefinitely for use in future years. (BUT – with new 80% NOL cap and excess business loss rules, have more barriers to use in future years.)
- Also, the limitation is on net interest expense. Lending businesses that both receive and pay significant amounts of interest may not be affected.

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Application to C Corporations

- The final regulations provide that all interest expense of a C corporation is treated as business interest expense that is subject to IRC 163(j) and that all interest income is business interest income for IRC 163(j) purposes.
- For affiliated but non-consolidated corporations, the various IRC 163(j) calculations are done on a separate entity basis.
- For consolidated groups, the IRC 163(j) calculations are done on a consolidated basis. HOWEVER – separate entity calculations are needed to allocate interest expense to the different members.

Application to CFCs

- The interest expense cap applies to CFCs (i.e., foreign corporations with the requisite direct or indirect U.S. ownership).
- Thus, IRC 163(j) will have a direct effect on how much interest can be deducted by a CFC, which will impact many calculations of CFC items such as subpart F income.
- The default rule is that IRC 163(j) applies to CFC on a separate entity basis.

Application to CFCs

- The proposed regulations allow taxpayer to elect to calculate IRC 163(j) under the “CFC Group Method.”
- As with members of a consolidated return group, all the relevant items are first computed on a separate entity basis (i.e., current year business interest expense, BIE carryforwards, business interest income and ATI).
- Then an electing CFC group aggregates all these items to compute a group-wide 163(j) limitation.

Application to CFCs

- A CFC Group for these purposes is subject to complicated rules, but generally at least 80% of a CFC's stock by value must be held by a single U.S. shareholder or by a group of related U.S. shareholder who own stock in the CFCs in the same proportions.
- The final regulations reserved on these rules – they appear in the 2020 proposed regulations and we await their finalization.

2. Exemptions from the Rules

$25 million Exception

- The new cap only applies to businesses with gross receipts of $25 million or less per year.
- This test is imported from the gross receipts test set forth in the cash method of accounting in IRC §448(c) and incorporates all the caveats and details for that test.
- The cash method gross receipts test is applied at the entity level. I.e., you test at the corporation or partnership level. However, you are required to aggregate entities that would be treated as a single employer under IRC §52(a) or (b) or IRC §414(m) or (o).
- So affiliated partnerships will be treated as one entity for these purposes. Ditto for consolidated groups, etc.

Real Estate Exception

- The new cap contains a significant exception for an “electing real property trade or business.”
- This is defined as any trade or business which is described in IRC §469(c)(7)(C), and makes the required election.
- IRC §469(c)(7)(C), covers “any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.”
- The legislative history makes clear that this exception applies to real property trades or businesses conducted by a corporation or a REIT and applies to operating or managing a lodging facility.

Real Estate Exception

- There is an important quid-pro-quo for the real estate exception.
- If a business makes the election, then it must compute tax depreciation under the MACRS alternative depreciation system (ADS) for nonresidential real property, residential rental property and qualified improvement property.
- Note that in many cases the change in tax depreciation for nonresidential real property and residential rental property for MACRS versus ADS is not large, but it should be factored into any modeling.

Farming Exception

- A similar exception to the cap applies to farming business.
- This exception incorporates the farming definition of IRC §263A(e)(4) and requires the taxpayer to elect into the exception.
- Like the real estate exception, there is a quid-pro-quo in that electing farm businesses have to use ADS for any assets with a MACRS recovery period of 10 years or more.

Regulated Utilities

- The cap is subject to an exception for certain regulated utilities.
- To qualify, the business must
  - involve the furnishing or sale of electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, and
  - the rates for such furnishing or sale must be established or approved by a state or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

Floor Plan Financing Exception

- The cap is subject to an exception for “floor plan financing interest.”
- This is defined as interest paid or accrued on floor plan financing indebtedness.
- Floor plan financing indebtedness means indebtedness used to finance the acquisition of motor vehicles held for sale or lease, and secured by the inventory so acquired.
- For these purposes, the “motor vehicle” includes:
  - any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road;
  - a boat; or
  - farm machinery or equipment.

Investment Interest Exception

- By its terms the cap only applies to “business interest.”
- Accordingly, it should not apply to interest categorized as investment interest.
- A pure investment partnership may not be affected by this limitation (although there are other limitations on the deduction of investment interest).

3. Rules for Pass-Through Entities

Partnerships and S Corporations

- Special rules apply to interest expense that passes through from partnerships and s corporations.
- Like the rule for corporations, the cap is applied at the entity level, but in the case of pass-through entities there are more complications.
- Finally, slightly different rules apply for S corporations than for partnerships.

Interest Cap for Partnerships – Ex. 1

- The deduction limitation on interest expense from a partnership is determined at the partnership level.
- Example 1: XYZ corp is a 50% partner in Newco, a partnership. Newco has $200 of non-interest income and $40 of interest expense.
- Under the new limitation, Newco can deduct up to $60 of interest expense. Because Newco has only $40 of interest expense, the $20 difference is treated as "excess taxable income" ("ETI") and handled separately (see below).
- Newco nets the $200 income against the $40 expense, for net income of $160. $80 is allocated to XYZ.

Interest Cap for Partnerships – Ex. 1

- Assume XYZ has zero net income from the rest of its operations and $25 of interest expense. If it calculated its interest expense with the benefit of XYZ's $80 net allocation from Newco, it would be double counting.
- Conversely, if XYZ is unable to get some benefit from the fact that Newco has income in excess of what it needed to absorb its own partnership-level interest expense, it would hurt XYZ.
- To resolve this, XYZ is not permitted to include any income from Newco's partnership operations in XYZ's own calculations, except that XYZ is permitted to deduct an amount of its own interest equal to its share of Newco's ETI.

Interest Cap for Partnerships – Ex. 1

- Recall that Newco had $20 of ETI, which is allocated among partners in the same ratio as each partner's share of nonseparately stated taxable income or loss.
- Thus, XYZ is allocated $10 of Newco's ETI and can deduct $10 of its $25 of entity-level interest expense.

Interest Cap for Partnerships – Ex. 2

- Example 2: Same facts, but Newco has $100 of non-interest income and $40 of interest expense.
- Thus, the partnership can only deduct $30 of interest expense and the remaining $10 is treated as “excess business interest” (“EBI”) and specially treated. As a result, Newco has $70 of net income.
- In this scenario there is no ETI for the partnership, but the EBI is allocated to each partner in the same proportion as nonseparately stated taxable income or loss.
- In the case of XYZ, Newco allocates $35 of net income to XYZ (50% x $70) and separately reports $5 of EBI to XYZ (50% of $10).

Interest Cap for Partnerships – Ex. 2

- In the next year, XYZ can deduct the $5 of EBI only to the extent of ETI allocated to it by Newco. It cannot be offset against other income or against ETI from a different partnership. EBI is not carried forward by Newco into a future year (*but is carried forward at the partner level*).
- Furthermore, XYZ's basis in Newco is reduced (but not below zero) by any EBI at the time it is allocated. However, if and when Newco allocates ETI to XYZ in a subsequent year and the EBI is deducted for tax purposes, there is no additional basis reduction.
- If XYZ sells its partnership interest in Newco before any EBI is deducted, any remaining basis reductions attributable to EBI are eliminated (restored).

Interest Cap for S Corporations

- The excess business interest (EBI) mechanism does not apply to S corporations.
- Thus, if an S corporation cannot deduct all its interest expense, the disallowed portion carries forward within the S corporation. The corresponding EBI basis mechanics also do not apply to S corporations.

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Interest Cap for Pass-Throughs

- These rules will add additional complexity to the operation of both partnerships and S corporations, but partnerships will suffer a higher burden than S corporations.
- As noted, the House Ways and Means Committee proposal that was released on September 13, 2021, would revise the foregoing rules for partnerships and S corporations by computing the limitation as the owner level, rather than at the entity level.

4. Structuring Within the Rules

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Net Interest Structuring

- The cap on interest applies to the excess of total business interest expense over total business interest income plus floor plan financing interest expense.
- The use of separate entities to borrow funds and to hold notes that are acquired with borrowed funds could cause problems.
- In an economic sense, the interest income and interest expense should offset each other. However, if these activities occur in separate entities, then they may not net.

Net Interest Structuring

- The use of affiliated borrowers and lenders will not always net.
- Recall that the rules applicable to partnerships and S corporations are different from the rules applicable to C corporations.
- So interest income received by one entity may not offset interest expense arising in a separate entity.
- Although testing for corporations is on a consolidated basis, testing for pass-throughs is at the entity level, not at the beneficial owner level.

Net Interest Structuring

- Key – do no confuse the affiliated entity definition for the $25 million gross receipts test with the rules on entity-level disallowance.
- A partnership and a corporation may be aggregated under the $25 million gross receipts test, but the interest expense cap will be applied separately to these two corporations.
- Some relief can be had by re-structuring partnerships into affiliated corporations and/or restructuring entities to be disregarded divisions of another entity. In both cases, the re-structured entities will be able to net their income or expenses against the parent entity's expense or income.

Gross Receipts Structuring

- Another approach is to structure businesses so that they will not be affiliated with other businesses. This will make it easier to come with the $25 million gross receipts test and thereby avoid application of the cap altogether.
- Caution – the affiliation rules under the $25 million gross receipts test are far reaching and difficult to navigate. In many cases it may not be possible to divide up an existing business to come under the threshold.

Accounting Method Planning

- The cap does not change the accounting method that applies for purposes of determining the timing of interest income and expense.
- Under the cash method, interest expense generally does not get deducted until a payment is made. Interest income is generally not included in income until received in cash.
- Under the accrual method, expense and income amounts are included on the basis of economic accrual.
- Interest on debt instruments subject to the OID rules be included/deducted on an economic accrual basis even if the taxpayer is on the cash method.

Accounting Method Planning

- Careful analysis of the characteristics of debt instruments held or issued by a given entity should be undertaken to maximize the netting of income and expense.
- In some cases, it may make sense to elect to treat all interest as OID so that income and expense match better, or to elect into the accrual method.
- Also, be certain you are taking into account any interest deferrals (for example, the related party interest expense deferral rules under IRC §267(a)(2)).

Consolidation Planning

- As noted, the cap applies on a consolidated basis, but applies on a separate company basis to affiliated but not consolidated corporations.
- This may permit structuring to take advantage of these different definitions.
- Example: A consolidated group has a 75% interest in Newco, a corporation. If Newco has significant amounts of business interest income, it may make sense to acquire another 5% of Newco so that Newco would be included in the consolidated group and its business interest income could offset the rest of the group's business interest expense.

5. Alternatives to Debt

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Alternatives – Lease Structures

- The cap only applies to interest.
- In many cases, a transaction can be re-structured so that it is taxable as a lease for federal income tax purposes.
- In that case, the lease payments would not be subject to the 30% threshold.
- Note, however, that if such lease payments create an overall loss, the new excess business loss and 80% NOL rules may pose barriers.

Lease Structures – Example

- Assume Newco borrows funds to purchase equipment. The interest on the loan is $45 in year 1. Assume Newco's specified income amount for purposes of the cap is $100.
- Only $30 of the interest is currently deductible in year 1. The balance – $15 – is carried forward into year 2 and possibly beyond.
- Assume now that Newco instead leases the equipment pursuant to an arrangement that qualifies as a lease under federal income tax principles. Assume the lease payment is $50 in year 1.
- Because the payment does not constitute interest, it is deductible in full in year 1.

Lease Structures – Example

- Generally, a lessee will pay more for a lease arrangement than a loan arrangement.
  - Although the lessee will lose the ability to take depreciation/expensing/amortization deductions associated with the underlying property, the lessor will be entitled to them and will factor this tax benefit into the rental rate.
  - Overall, a lease represents more risk to the lessor than a loan. Accordingly, the implicit finance rate is higher.
  - A lease period is often faster than some commercial loan periods – it will often be a function of the useful life of the underlying property.

Lease Structures – Example

- As noted the lessee will not be entitled to cost recovery deductions associated with the underlying property.
- Also as noted, the interest cap is measured by 30% of the taxpayer's specified income amount, and that starting in 2022, this amount is computed without regard to cost recovery deductions.
- As a result, by eliminating interest expense and cost recovery deductions, the threshold is increased with result that the cap will apply to less of Newco's remaining business interest expense.

Lease Structures – Example

- While a lease arrangement can avoid the interest expense cap, it comes with a generally higher price tag and more legal and accounting complexity.
- In addition, if the lender is a foreign entity, this type of arrangement may not work as a replacement to a loan.
- Generally, interest on loans from foreign taxpayers will qualify for an exemption from withholding under the portfolio debt rules. This exemption may be critical to the deal structure.
- But – certain tax treaties will exempt rental payments associated with certain industries (aviation, maritime, etc.)

Alternatives – Installment Sales

- Assume that Newco wants to borrow $100 to purchase a piece of equipment for the same price. A bank would be willing to lend the money at an interest rate of 10%.
- Newco, however, becomes concerned that the cap would disallow some or all of the interest.
- Dealerco, a buyer and seller of similar equipment offers to buy the exact piece of equipment that Newco wants and then sell it over time to Newco for $105, with a stated interest rate of 5%.
- The lower stated interest rate will produce less interest expense that is subject to the cap.

Alternatives – Installment Sales

- In effect, Dealerco is taking a price mark up as a tradeoff for a market interest rate.
- From Dealerco's perspective, it may be indifferent to the tax characterization of a return as interest income or dealer profit.
- From Newco's perspective, the lower interest rate minimizes the amount of interest that could be subject to the cap. Effectively, half the interest will be converted into basis in the equipment. This will either yield depreciation deductions going forward or upfront expensing deductions. In either case, Newco may be better off with respect to this transaction and will preserve cap space for existing interest expense obligations.

Alternatives – Installment Sales

- This arrangement could be subject to re-characterization.
- If the interest rate is below market, then the IRS could try to re-characterize some of the dealer mark up as disguised interest.
- However, it would be common for a dealer to charge a markup and if the stated interest rate is at least the AFR, Newco could argue that further scrutiny is not required under the installment sale rules.

Alternatives – Partnership Preferred Equity

- Another alternative is to replace debt with partnership preferred equity.
- This approach is simplest to explain in the context of a business carried on by a partnership but, with somewhat more complexity, can also be applied in the context of a corporate entity.
- In essence, the debt expense is replaced with a partnership preferred return allocation that is treated as equity for income tax purposes.
- From the preferred partner's perspective, the receipt of interest income and a preferred return are generally both taxed as ordinary income, so the partner should be indifferent to the characterization.

Partnership Preferred Equity Example

- Newco is a partnership with several members. It desires to borrow $100. Investco, a private equity group, is willing to lend that amount at a 10% rate. Investco also requires various warrants, etc.
- During the diligence process, Newco discovers that all the interest on the loan will be subject to the cap and disallowed.
- Moreover, the issuance of the warrants will create OID that will increase Newco's interest expense for GAAP and tax purposes, all of which will be disallowed under the cap along with the stated interest.
- The GAAP and tax consequences can make the loan and warrant approach very hard to sell.

Partnership Preferred Equity Example

- After much discussion, Newco and Investco agree on the following arrangement:
  - Investco contributes $100 as equity to Newco in exchange for 100 preferred units.
  - The units entitle Investco to a 10% cumulative preferred return on the capital contribution. That is, the units are entitled to this return if and to the extent that Newco has sufficient cash flow and such payments occur before any other equity payments.
  - The units are convertible into Newco's common units and give Investco the same upside protection as warrants would.

Partnership Preferred Equity Example

- For tax purposes, the preferred units are treated as partnership equity. It is possible that they will also be treated as equity for GAAP purposes, which would strengthen Newco's balance sheet.
- From Newco's perspective, the allocation of preferred return to Investco reduces the taxable income of the partnership that would otherwise be allocated to the common units. In effect, the preferred return is "deductible" by Newco's common unit holders.
- In addition, because the preferred return is treated as equity, the OID rules do not apply. As a result, Investco is only taxable if and when the preferred return is allocated.

Partnership Preferred Equity Example

- From Investco's perspective, the preferred return is likely taxable as ordinary income, just like interest income would be.
- Moreover, this arrangement effectively converts interest expense that would otherwise be disallowed into income allocations that eliminate the preferred return from the taxable amounts otherwise allocated to the common units.

Closing Notes

- The interest cap likely will only be a problem for large and medium size businesses (the $25 million gross receipts test).
- The application of the cap to pass-through entities will be very complicated.
- Taxpayers will likely seek creative solutions around the cap and the IRS will just as likely set reasonable barriers to these efforts.

Thanks!

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KPMG

State and local tax considerations for IRC 163(j)

October 26, 2021

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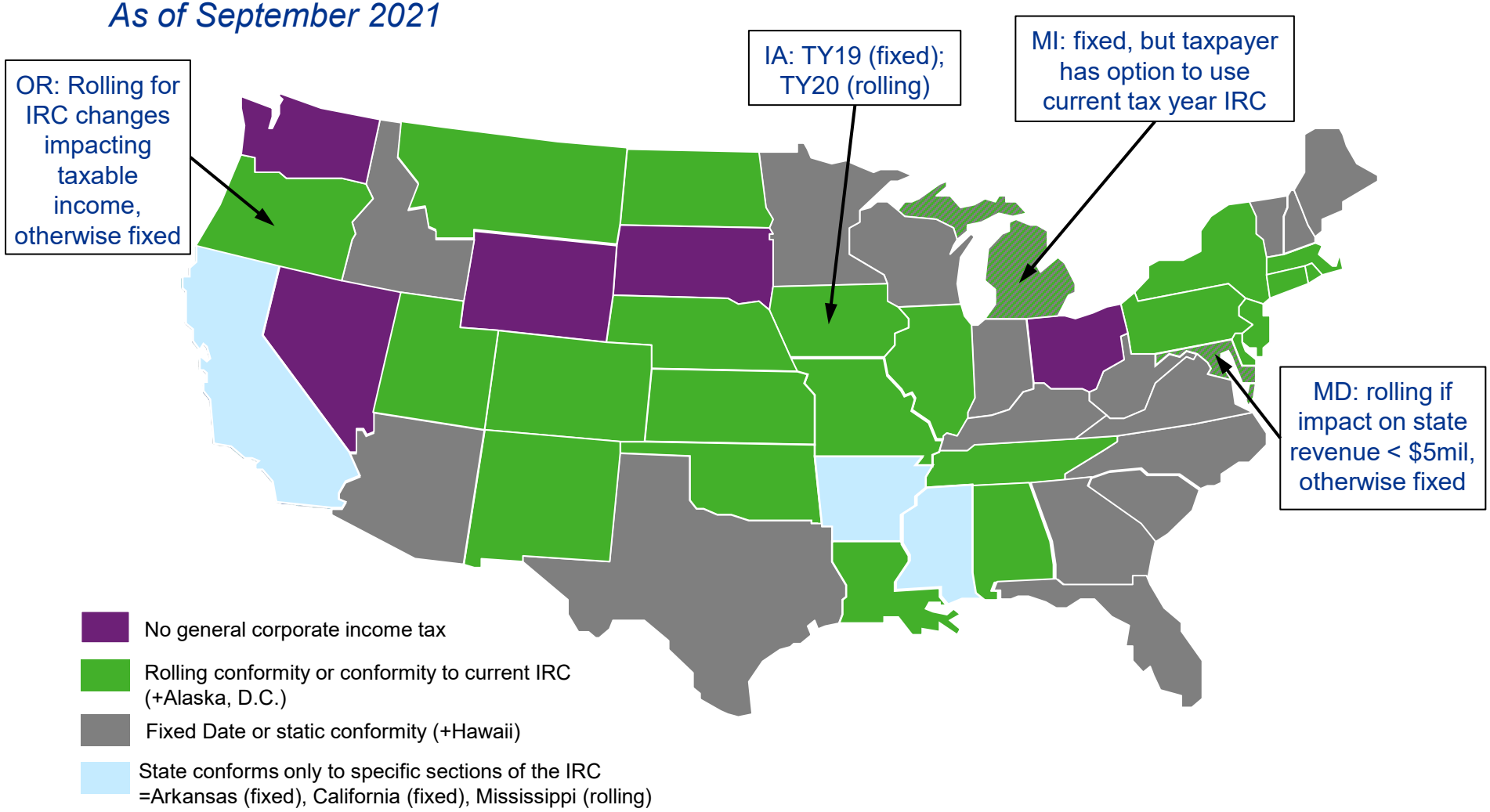
SALT and IRC 163(j) – corporate IRC conformity

SALT and IRC 163(j) - background

- SALT tax base interaction with federal limitation
  - Does the state conform to post-TCJA Section 163(j)?
    - If not, does state still conform to pre-TCJA Section 163(j)?
  - Does the state conform to post-CARES Act Section 163(j)?
- Other SALT tax base and computational issues
  - State filing group differences and “as if separate” computations
    - If the federal limitation is computed on a consolidated group basis, then how do the variations between federal and state filing methods impact the computation and application of the interest expense limitation?
    - Separate company vs. unitary combined vs. consolidated vs. nexus combined
    - Intercompany items
  - Carryforwards of disallowed interest expense
  - State-specific tracking schedules will be required

Corporate general state IRC conformity

As of September 2021

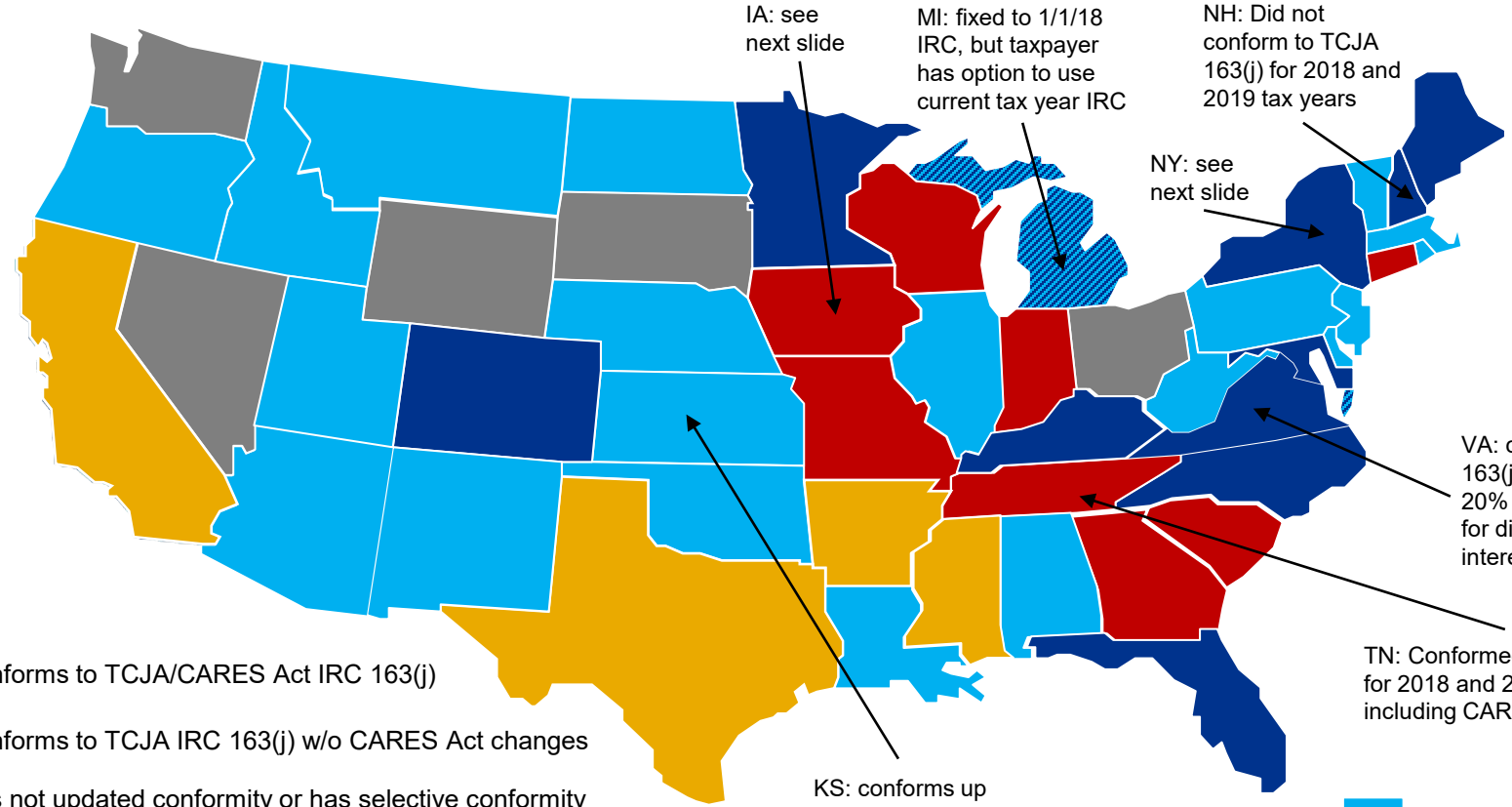


CARES Act impact for SALT

- IRC Conformity for CARES Act changes to IRC 163(j)
  - Rolling IRC conformity states, which haven't decoupled from IRC 163(j), generally adopted the reduced limitation (50% of ATI in limitation calculation)
    - These states may have also followed the election to use TY19 ATI in the TY20 limitation calculation, depending on state's computation, election rules, etc.
    - This has meant there is an even greater need for tracking that includes values for states that adopted the TCJA version of IRC 163(j) but that did not adopt the CARES Act changes to IRC 163(j)
  - Static IRC conformity states and nonconforming states did not adopt CARES Act changes to IRC 163(j) without additional legislation
    - Certain states updated IRC conformity for CARES Act changes, while others did not

Corporate state conformity IRC 163(j)

TY2020 chart as of September 2021



- Conforms to TCJA/CARES Act IRC 163(j)
- Conforms to TCJA IRC 163(j) w/o CARES Act changes
- Has not updated conformity or has selective conformity and has not adopted TCJA IRC 163(j)
- Decouples – specifically decoupled from post-TCJA 163(j)
- No general corporate income tax

- Alaska
- District of Columbia
- Hawaii

SALT IRC conformity changes - Colorado

- Colorado CARES Act decoupling legislation
  - Specifically decoupled from CARES Act changes including IRC 163(j), see House Bill 20-1420 (signed into law on July 11, 2020) by requiring taxpayers to add back business interest deductions taken on the federal return in excess of the limits imposed under the TCJA version of IRC 163(j) before the CARES Act
- Colorado CARES Act modification legislation
  - House Bill 21-1002 (signed into law on Jan. 21, 2021) provides that for tax years on or after January 1, 2021, corporations must take certain subtraction modifications to offset previous decoupling from certain CARES Act provisions
  - Beginning on or after January 1, 2021 but before January 1, 2022, corporations have a subtraction modification in an amount to offset the loss of the CARES Act benefits related to IRC 163(j) and QIP (qualified improvement property)
  - The subtraction allowed each year applies after the application of other statutory subtractions permitted to corporations, including the Colorado NOL deduction
    - For tax year 2021, the subtraction is capped by the lesser of the taxpayer's state taxable income or $300,000
    - For tax years 2022 through 2025, the subtraction is capped at the lesser of the taxpayer's state taxable income or $150,000
    - For tax years after 2026, the subtraction will be limited by the taxpayer's taxable income without a specific cap

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SALT IRC conformity changes - Iowa

- Iowa IRC conformity changes
  - TY2018: IA fixed conformity to IRC did not conform to IRC 163(j)
  - TY2019: IA fixed conformity to IRC conformed to IRC 163(j) pre-CARES Act
  - TY2020 and forward: IA rolling conformity to IRC but decoupled from IRC 163(j)

- Iowa IRC 163(j) tracking of conformity adjustments
  - Changes in conformity have created a need to track state interest expense deductions taken in TY2018 and in TY2020/forward that will not be permitted in a future tax year when a federal interest deduction becomes available
  - As a result, taxpayers will need to track any state interest expense deduction not taken in TY2019 that may be taken in a later tax year when a federal deduction is taken

SALT IRC conformity changes - Iowa

- Reporting
  - IA 101 Nonconformity Adjustments - reports and tracks adjustment
  - Part II is used for tracking carryforward issues resulting from IA's 2018 nonconformity, but not IA 2019 nonconformity with the CARES Act

Part II: Accumulated IA 101 Nonconformity Adjustments

	A 2018 Nonconformity Adjustment Amount	B IA 101 Nonconformity Adjustments claimed in prior years	C Current Year IA 101 Nonconformity Adjustment	D Amount remaining as adjustments for future years on IA 101
a. Contributions to Capital				
b. Limitations on Business Interest Expense				

SALT IRC conformity changes - MD and NY

- Maryland decoupling legislation
  - Specifically decoupled from CARES Act changes including IRC 163(j), see MD Comptroller Report, which was released on 6/12/2020
  - Provides that Maryland decouples from CARES Act changes for the 2020 tax year because the state tax revenue impact is greater than $5 million, but conforms to CARES Act changes for the 2018 and 2019 tax years

- NYS and NYC decoupling legislation
  - Specifically decoupled from CARES Act changes including IRC 163(j), see S7508, which was signed into law on 4/3/2020
    - NYS Exception: election to use 2019 ATI for TY2020 was available on NYS Article 9-A returns
    - NYC: election to use 2019 ATI for TY2020 was <u>not</u> available on NYC returns, per S8411 (signed 6/17/2020), see NYC Finance Memo 20-6

Selected state and local tax approaches

Separate company return limit - Alabama

- How is a federal consolidated limitation computation handled on a state separate company return?
- Alabama House Bill 170 (signed February 12, 2021)
  - For tax years beginning on or after January 1, 2021, the bill addresses various questions related to Alabama's adoption of IRC section 163(j)
    - If a taxpayer or a taxpayer's federal consolidated group does not have a federal IRC section 163(j) limitation reported on its return for the tax year, it will not be subject to an Alabama 163(j) limitation
    - The gross receipts test under IRC section 163(j)(3) applies to each separate Alabama filer or to an Alabama consolidated group
    - For purposes of Alabama's related party interest addback rules, the 163(j) limitation applies before the application of the related party interest addback and the Alabama 163(j) interest deduction limitation
    - Any interest expense carryforwards will be allocated on a pro-rata basis

Example: Consolidated vs. Separate Limit

	Interest Income	ATI	Interest Expense	Allowable Deduction: Consolidated	Allowable Deduction: Separate Co
Corp A	$ -	$ 100	$ 400	$ 200	$ 30
Corp B	$ 200	$ 500	$ -	$ -	$ -
Corp C	$ -	$ 400	$ 600	$ 300	$ 120
Total	**$ 200**	**$ 1,000**	**$ 1,000**	**$ 500**	**$ 150**

— Consolidated limitation

- BIE limitation = $200 + (30% x $1000) = $500
  - Current year disallowed BIE = $500
- Corp A share of the consolidated limitation = $500 x ($400/$1000) = $200
- Corp C share of the consolidated limitation = $500 x ($600/$1000) = $300

— Separate company limitation

- Corp A separate limitation = $0 + (30% x $100) = $30
  - Current year disallowed BIE = $370
- Corp C separate limitation = $0 + (30% x $400) = $120
  - Current year disallowed BIE = $480

Combined return limit - Michigan

- Michigan Corporate Income Tax (CIT)
  - Notice: Corporate Income Tax Treatment of the IRC 163(j) Business Interest Limitation (June 8, 2020)
  - Rolling IRC Conformity - CIT tax base computation begins with FTI
  - Looked to 2018 federal proposed 163(j) regulations (REG-106089-18)
    - Federal: Consolidated return. Limitation applies at consolidated return level, with a single limitation for the consolidated return
    - Michigan Unitary Business Group (UBG):
      - Combined return. Michigan has consistently recognized that consolidated and combined filing are <u>not the same</u>
        - Michigan has required each UBG member included on a federal consolidated return to separately compute FTI on a pro forma federal return
      - All the components of a federal return are separately computed to arrive at a member's pro forma FTI, including the Michigan version of the member's interest expense limit, i.e., the state 163(j) limit
      - MI carryforward – value of disallowed BIE carryforward may vary from federal value

SALT reactions - Virginia

- Virginia Tax Bulletin 20-1 (2/18/20)
  - Virginia Senate Bill 582 (enacted Feb. 17, 2020) generally advanced the state's static conformity to the IRC as of 12/31/19 (from IRC as of 12/31/18)
  - Virginia continued to decouple from various TCJA provisions but continued to adopt the TCJA IRC 163(j) limitation
- Virginia Tax Bulletin 21-4 (3/15/21)
  - Virginia House Bill 1935 and Senate Bill 1146 generally advanced the state's static conformity to the IRC as of 12/31/20
  - Virginia has not specifically decoupled from IRC 163(j)
    - However, a subtraction is allowed for 20% of the business interest disallowed by IRC 163(j)
  - Virginia has specifically decoupled from the taxpayer-favorable changes to IRC 163(j) made by the CARES Act to the business interest limitation computation that applied for taxable years 2019 and 2020

States and electing RPTB - GA

- Real property trade or business (RPTB) election mechanics
  - Consider state's IRC conformity to IRC 163(j) and IRC 168.
- Georgia DOR website: Income Tax Federal Tax Changes (updated May 6, 2021)
  - Georgia follows the provisions of IRC 163(j) that existed before enactment of the Tax Cuts and Jobs Act.
  - Since Georgia follows the prior rules of IRC 163(j), Georgia does not recognize the provisions for an electing RPTB (IRC 163(j)(7)(a)(ii) and 163(j)(7)(B)).
  - Thus, for purposes of computing "federal income" for Georgia income tax purposes, the taxpayer would not be subject to the alternative depreciation method under IRC 168(g). Therefore, the taxpayer would depreciate assets as if the new provisions of IRC 163(j) had not been enacted.
  - This can result in different depreciation values for federal and Georgia purposes.

SALT - IRC 163(j) and expense disallowance

- Interaction between state conformity to 163(j) and expense disallowance
  - AL, DC, IL, KY, NJ, PA: apply 163(j) limit first, then related-party addback rules
  - MA TIR 19-17: apply state's related-party addback rules first, then 163(j) limit
- Illinois Sch. 80/20 instructions - example:
  - In Year 1 Taxpayer paid $100 in business interest to an 80/20 affiliate and $1,000 in total business interest. There is no carryforward under IRC Section 163(j)(2) from the prior year. Under IRC Section 163(j), Taxpayer's federal income tax deduction for interest in Year 1 is limited to $800. For purposes of computing the amount of interest to include on Line 3a for Year 1, the amount of interest Taxpayer is considered to have paid the 80/20 affiliate and deducted in computing base income equals $80 (the $100 actually paid multiplied by 80%). The carryforward of interest paid to the 80/20 affiliate in Year 2 equals $20 (the $100 actually paid multiplied by 20%).
    - $800 deduction after IRC 163(j) limit / $1000 total business interest = 80% deducted ratio
    - $100 paid * 80% deducted ratio = $80 deducted
    - 100% - 80% deducted ratio = 20% not deducted ratio
    - $100 paid * 20% not deducted ratio = $20 carryforward of interest paid to 80/20 affiliate

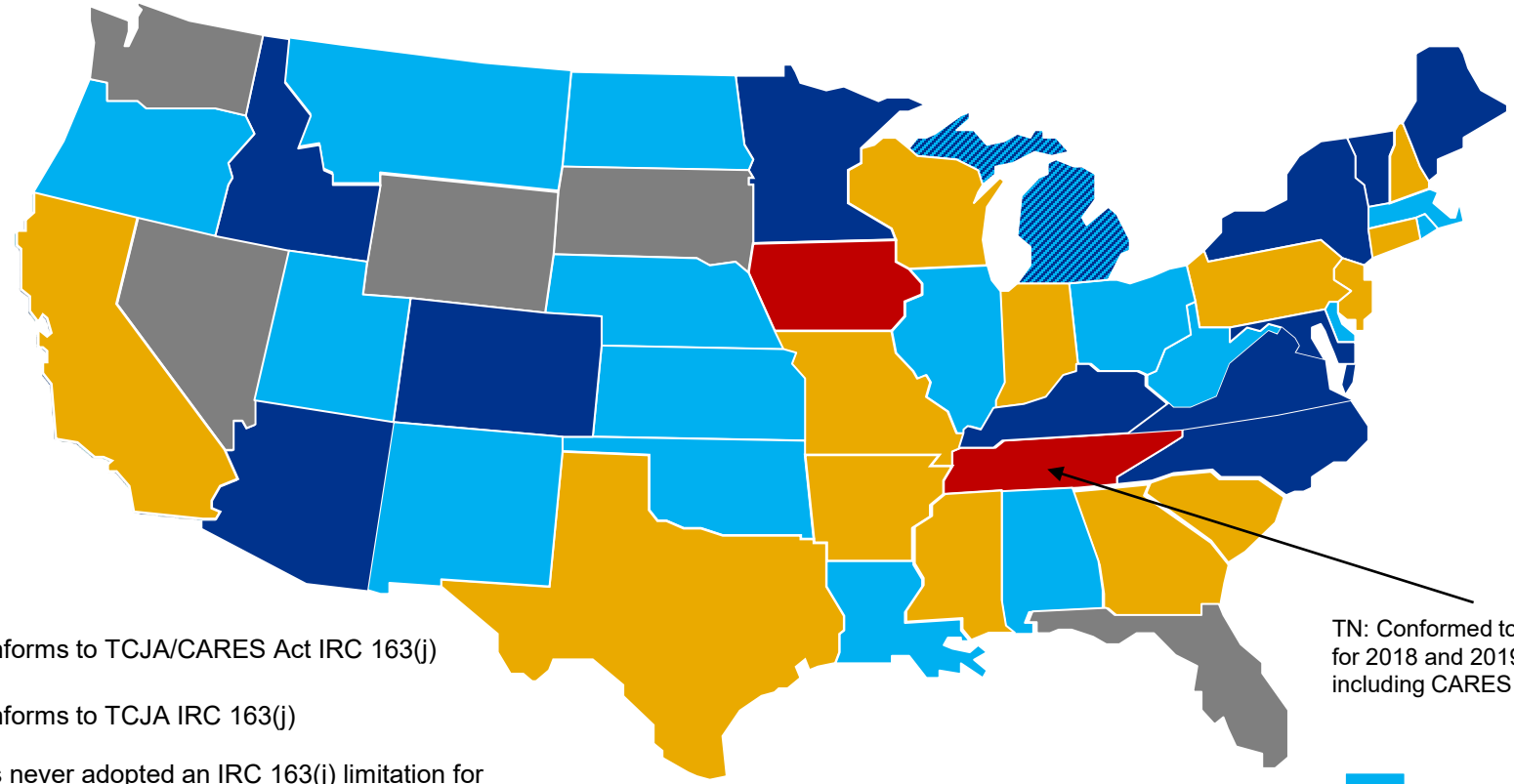
States and “old IRC 163(j)” carryforwards

- South Carolina Revenue Ruling #21-2
  - “South Carolina’s adoption of the Internal Revenue Code is not automatic and is not all inclusive”
  - South Carolina had conformed to pre-TCJA IRC 163(j), i.e., “old IRC 163(j)”
  - Starting with tax year 2018, there was no IRC 163(j) limitation, neither under the pre-TCJA rules nor the TCJA version
  - Based on the adoption of 2018 Act 266, the provisions of “old IRC 163(j)” were no longer adopted by South Carolina, so any interest expense carryforwards from years beginning before 2018 (under “old IRC 163(j)”) are no longer available

SALT 163(j) – partnerships

Partnership state conformity IRC 163(j)

TY2020 chart as of July 2021



TN: Conformed to TCJA 163(j) for 2018 and 2019 tax years including CARES Act changes

- Conforms to TCJA/CARES Act IRC 163(j)
- Conforms to TCJA IRC 163(j)
- Has never adopted an IRC 163(j) limitation for partnerships
- Decouples – specifically decoupled from post-TCJA 163(j)
- N/A

- Alaska
- District of Columbia
- Hawaii

SALT - IRC 163(j) and partnerships

- Does a jurisdiction adopt revised IRC 163(j)?
  - IRC conformity date – does it vary for partnerships?
  - State partnership modifications specific to IRC 163(j)
- Does a state or local jurisdiction require partnerships to pay tax at the entity level?
  - Even if the interest deduction is allowed at the partner level, the limitation at the partnership level could impact total state and local tax due
  - Elective “workaround” taxes at the partnership level
- Does this limitation impact nonresident withholding or other state partner reporting?
- Does this limitation impact the tax base on a composite return?
- Partner basis in partnership – is state-specific tracking required?

Partnerships and SALT reporting for 163(j)

— Line 13K – Excess business interest expense (EBIE)

- Conforming states
  - In computing an income tax or withholding base for states that conform to the current federal IRC 163(j) limit, Line 13K value would need to be:
    - 1) not deducted, or
    - 2) shown as a modification - if the Line 13K value is initially shown as deducted, then need to show as an addback modification too
  - Some state and local jurisdictions which impose income tax on partnerships conform to the TCJA IRC 163(j) limit, such as the New York City UBT and the Illinois Replacement Tax
    - CARES Act changes adopted by IL (rolling conformity)
    - NYC UBT has specifically decoupled from the CARES Act TY19 and TY20 changes (S7508 passed 4/3/20; S8411 passed 6/17/20)
- Decoupling states
  - States may display recomputed interest deduction with no IRC 163(j) limit
  - States may initially display the federal (limited) value, then need to show the additional state interest deduction as a subtraction modification

SALT reactions - NYC UBT (partnership tax)

- NYC Finance Memoranda #18-11 (Unincorporated Business Tax)
  - Unincorporated business deductions are deductions allowed for federal purposes, subject to statutory modifications. Generally, interest expenses deducted for federal purposes flow into unincorporated business income without any adjustments, unless otherwise specified by statute
  - The limitation under IRC §163(j) may affect the attribution of interest expenses between business and investment capital…[#18-11 includes sample computations]
  - No amount of interest expense allocated to a partner as excess business interest will be deductible on the partnership's UBT return for any succeeding taxable year…
  - UBT taxpayers…that are partners in a…lower-tier partnership…may [potentially] deduct the carryforward of business interest expense allocated to it by the lower-tier partnership…[depending on if the lower-tier partnership was taxable, fully exempt, or partially exempt]

Thank you

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