



CORPORATION TAX BULLETIN 2019-03

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PENNSYLVANIA CORPORATE NET INCOME TAX TREATMENT OF IRC § 163(j)

Overview

The Tax Cuts and Jobs Act of 2017 amended Section 163(j) of the Internal Revenue Code (the “Code”). For Federal income tax purposes, Section 163(j) limits the deductibility of interest expense in the current tax year of certain U.S. taxpayers for tax years beginning on or after January 1, 2018. This Bulletin provides guidance on how the Federal limitations imposed by the amended Section 163(j) are treated for Pennsylvania Corporate Net Income Tax (“CNIT”) purposes.

Federal Treatment of Interest Expense under Code Section 163(j)

Code Section 163(j), as amended by the Tax Cuts and Jobs Act of 2017, limits the deduction for business interest expense for tax years beginning after December 31, 2017 to the sum of:

1. The taxpayer’s “business interest income”;
2. 30% of the taxpayer’s “adjusted taxable income”; plus,
3. The taxpayer’s “floor plan interest”.

On November 26, 2018 proposed federal regulations were issued addressing the interest expense limitations contained in Code Section 163(j) and related implications. As clarified by these proposed Federal regulations, a Federal consolidated filing group would have a single Code Section 163(j) limitation and consequently all individual corporations participating in the filing of a single Federal consolidated return would be treated as a single taxpayer for purposes of performing the necessary calculations to determine the applicable interest expense limitation, if any, to apply. Given this Federal result, amounts representing intercompany transactions between corporate members of a single Federal consolidated return would need to be eliminated and not taken into consideration as part of calculating the Code Section 163(j) limitation applicable to the group. While exceptions will of course exist, specifically for the consolidated return provisions of the proposed regulations, it is the general intent that the proposed regulations will be followed to the extent practicable in preparing the taxpayer’s pro-forma Federal interest expense deduction under Code Section 163(j) for purposes of calculating its Pennsylvania taxable income.

Federal Consolidated Filers

As a threshold issue, the Department will not expect any Pennsylvania corporate taxpayer which files its federal return on a consolidated basis to limit its separate company interest expense deduction for Pennsylvania purposes in a given tax period unless the federal consolidated group of which it is a part reports an interest expense limitation under Code Section 163(j) on the group’s consolidated federal form 1120 filed with the federal tax authorities for that same tax period. If the federal consolidated group reports an interest limitation under Code Section 163(j), then each member with a Pennsylvania CNIT filing obligation will need to perform its own set of calculations on a separate company basis in order to determine if the interest expense limitation applies to it. This separate company analysis will include determining whether the individual entity has gross receipts sufficient to meet the requirements of Code Section 163(j)(3), when calculated on a separate entity basis without elimination of related party receipts.



Additionally, for purposes of implementing Code Section 163(j) Pennsylvania will follow any elections actually made for federal purposes by the taxpayer or its federal consolidated group under subparagraphs (B) or (C) of Code Section 163(j)(7).

Affected Taxpayers

Taxpayers subject to CNIT may have their taxable income impacted by the net interest limitation. Generally, taxpayers will need to calculate their Federal interest expense deduction on a separate entity basis. However, taxpayers may also face more specific situations, such as treatment of nonbusiness income as well as the Pennsylvania specific addback of certain related party interest expense deductions. Situations may also arise for corporations with partnership interests. Guidance for these situations is provided below.

Pennsylvania Treatment of Federal Interest Expense

As codified in 72 P.S. § 7401(3)1.(a), taxable income is defined for CNIT purposes as “taxable income ... as returned to and ascertained by the Federal Government, or in the case of a corporation participating in the filing of consolidated returns to the Federal Government, the taxable income which would have been returned to and ascertained by the Federal Government if separate returns had been made to the Federal Government for the current and prior taxable years¹ As such, absent specific legislation decoupling a taxpayer’s Federal interest expense deduction amount for Pennsylvania CNIT purposes, taxpayers are compelled to utilize the Federal interest expense deduction calculated on a separate entity basis for purposes of computing their Pennsylvania CNIT taxable income. Therefore, taxpayers will need to continue to include intercompany and third-party interest in their calculation of interest expense under Code Section 163 generally as well as when calculating the limitation imposed by Code Section 163(j) for purposes of their separate company Federal taxable income.

Based on the inclusion of intercompany interest expense in the calculation, the Department recognizes that the Code Section 163(j) limitation and resulting Federal carryforward amount for purposes of the taxpayer’s pro-forma Federal Form 1120 may differ substantially from the amounts reportable to the Internal Revenue Service for Federal income tax purposes.

¹Note that this will extend to foreign entities which claim exemption from the imposition of federal income tax but have sufficient nexus with Pennsylvania to trigger the filing of a CNIT return. In keeping with current practice, such an entity will need to prepare a pro-forma Federal income tax return and compute its own interest expense limitation under Code Section 163(j) as part of calculating its taxable income.



Interest Expense Associated with Addback Provision

To the extent a taxpayer has interest expense or costs that fall within the definition contained in 72 P.S. § 7401(3)1.(t), as well as a Federal limitation under Code Section 163(j), an issue arises as to the proper Pennsylvania CNIT treatment of the respective interest amounts. In such situations, the Department will expect taxpayers to allocate the Federal limitation on a pro-rata basis between the two amounts. Specifically, a fraction consisting of the Federal interest expense after application of the limitation over total interest expense without regard to the limitation, multiplied by their Pennsylvania “Interest expense or cost” should provide a taxpayer the amount of current year related party interest potentially subject to addback. Since the Federal carryforward provisions make no distinction between related party interest and third party interest, disallowed related party interest would carry forward and potentially be deductible for Federal separate company purposes in future tax periods. As a result taxpayers should track not only their Federal separate company interest deduction carryforward but also the breakout of that amount between third party interest expense and interest expense falling within 72 P.S. section 7401(3)1.(t).

If and when the interest expense which was previously disallowed becomes fully deductible on a Federal separate company basis, the taxpayer would follow the analysis for the year of the original expense to determine whether the related party interest should be added back for Pennsylvania purposes. To the extent the previously disallowed interest becomes partially deductible for federal separate company purposes in a future tax year a separate calculation will need to be performed in order to calculate the accurate Pennsylvania addback amount and update the Pennsylvania specific interest addback carryforward. This calculation will again be done on a pro-rata basis and will involve a fraction consisting of the amount of the carryforward interest deducted in the current year over the total amount of the carryforward interest at the start of the tax year, multiplied by the existing Pennsylvania specific interest addback carryforward. The resulting amount will be added back in the current year on the taxpayer’s Corporate Tax Report.

See below for examples of these calculations:



Example 1 - PA Interest Deduction Addback Partially Added Back in a Future Year			
	2018	2019	2020
Adjusted Taxable Income	1,000,000	1,200,000	2,000,000
30% of Adjusted Taxable Income	300,000	360,000	600,000
Business Interest Income	-	-	-
Floor Plan Financing Interest	-	-	-
Limitation on Business Interest Expense	300,000	360,000	600,000
Total Current Year Business Interest Expense	350,000	350,000	350,000
Interest Limitation Carryforward from Prior Year	-	50,000	40,000
Total Business Interest Expense	350,000	400,000	390,000
Current Year Interest Deduction with IRC 163(j) limitation	300,000	360,000	390,000
Federal Carryforward Amount Deducted in Current Year	-	10,000	40,000
Total Federal Carryover Amount	50,000	40,000	-
PA Interest Addback per 72 P.S. 7401(3)1(t) - current year only	100,000	200,000	150,000
Ratio (current year interest after limitation/current year total interest)	0.86	1.00	1.00
PA Current Year Interest Addback	85,714	200,000	150,000
PA Carryforward Interest Added Back ((federal carryforward amount deducted in current year/total federal carryover amount) * PA Interest Limitation carryforward amount))	-	2,857	11,429
PA Current Year Interest Addback from Partnerships	-	-	-
Total PA Interest Addback	85,714	202,857	161,429
PA Interest Limitation Carryforward	14,286	11,429	-



Example 2 - PA Interest Deduction Addback Fully Added Back in a Future Year			
	2018	2019	2020
Adjusted Taxable Income	1,000,000	800,000	2,000,000
30% of Adjusted Taxable Income	300,000	240,000	600,000
Business Interest Income	-	-	-
Floor Plan Financing Interest	-	-	-
Limitation on Business Interest Expense	300,000	240,000	600,000
Total Current Year Business Interest Expense	350,000	350,000	350,000
Interest Limitation Carryforward from Prior Year	-	50,000	160,000
Total Business Interest Expense	350,000	400,000	510,000
Current Year Interest Deduction with IRC 163(j) limitation	300,000	240,000	510,000
Federal Carryforward Amount Deducted in Current Year	-	240,000	510,000
Total Federal Carryover Amount	50,000	160,000	-
PA Interest Addback per 72 P.S. 7401(3)1(t) - current year only	100,000	200,000	150,000
Ratio (current year interest after limitation/current year total interest)	0.86	0.69	1.00
PA Current Year Interest Addback	85,714	137,143	150,000
PA Carryforward Interest Added Back ((federal carryforward amount deducted in current year/total federal carryover amount) * PA Interest Limitation carryforward amount))	-	-	77,143
PA Current Year Interest Addback from Partnerships	-	-	-
Total PA Interest Addback	85,714	137,143	227,143
PA Interest Limitation Carryforward	14,286	77,143	-



Interest Expense associated with Nonbusiness Income

Pursuant to current law, to the extent interest expense relates to business income in the hands of the taxpayer, the interest expense serves to reduce business income and to the extent it is associated with nonbusiness income the interest expense serves to reduce the nonbusiness income. For periods starting after December 31, 2017 to the extent a Pennsylvania corporate taxpayer has a Code Section 163(j) interest expense limitation and also reports nonbusiness income, it should make a determination of the amount of overall interest expense associated with the nonbusiness income and allocate an interest limitation to that amount on a pro-rata basis. Thereafter the interest expense carryforward amount associated with the taxpayer's nonbusiness income can only be used to offset nonbusiness income amounts in future periods.

Treatment of Interest Expense Amounts for Partnerships with Corporate Partners

For Federal purposes, the interest expense limitation is calculated for partnerships at the partnership level itself but then applied at the partner level. The Department intends to follow that result for CNIT purposes. As a result, once a partnership calculates its own Federal interest limitation amount pursuant to Code Section 163(j), those interest and excess business interest expense amounts will flow to its corporate partner(s) in the same manner and percentage as other amounts flow up from the partnership to its corporate partner(s). In a tiered structure this would result in a fixed interest limitation amount flowing up through multiple levels until it reaches one or more corporate taxpayers. The corporate partner would then follow the federal rules unique to partners and partnerships for determining when or to what extent the excess business interest expense could be deducted by the corporate partner on a separate entity basis.

It is also important to note that while for purposes of calculating federal adjusted taxable income all interest of a C corporation is treated as "business interest", unless the amounts are designated to a specifically excluded type of business under Proposed Reg. § 1.163(j)-10. However, this same treatment does not extend to the interest limitation calculation that must be made by a partnership. As a result partnerships will need to identify whether interest is properly classifiable as "business interest" as part of calculating the interest limitation passed through to its corporate partner(s). For purposes of this calculation, partnerships will need to rely on federal guidance as the classification of business interest for federal income tax purposes does not correlate with a determination of business vs. nonbusiness income under existing Pennsylvania authority. Ultimately, the corporate taxpayer will still need to make the determination under Pennsylvania authority whether the interest amounts flowing through from the partnership represent business or nonbusiness income for CNIT purposes.

Finally, to the extent a partnership has interest expense or costs that fall within the definition contained in 72 P.S. § 7401(3)1.(t), as well as a Federal limitation under Code Section 163(j), the same issues arise as when a corporation engages in such transactions. Accordingly, the Department expects that when corporate taxpayers receive their share of the interest and excess business interest amounts from each of the partnerships in which they own an interest, the corporate taxpayer will then need to make the necessary calculations in order to determine the amount of the Code Section 163(j) interest limitation to report on its pro-forma federal form 1120. The corporate taxpayer will also need to determine its Pennsylvania interest expense addback from each such partnership and report it on its Pennsylvania Corporate Tax Report for that year. Similar to the methods outlined previously in this bulletin, the corporation will need to track these amounts on a partnership-by-partnership basis in order to ensure that future Pennsylvania addback amounts are included when the corresponding interest expense is able to be deducted for federal separate company income tax purposes.



Personal Income Tax Treatment

In the context of the Pennsylvania Personal income tax (“PIT”) the deductibility of interest costs and expenses are determined based whether they constitute ordinary and necessary business expenses, and not by linking them to particular sections of the Code. Accordingly, for PIT purposes the determination of whether and the extent to which interest expenses are deductible should continue without change for periods commencing after December 31, 2017.

For purposes of the calculation of the resident credit, a Pennsylvania resident determines his income in another state according to its rules and calculates his tax liability in that state accordingly. The taxpayer may then take a resident credit based on income taxed by both states, but as always, the credit cannot exceed the Pennsylvania tax liability on the income as determined under Pennsylvania law. Accordingly, to the extent a taxpayer realizes increased income in another state based on the application of the limitations under Code Section 163(j) by that state, the calculation of the taxpayer’s resident credit should not be affected, as it is limited to the Pennsylvania tax applied to the income as calculated under the applicable Pennsylvania rules.

Future Guidance

It is anticipated that additional guidance regarding the Pennsylvania CNIT implications of Code Section 163(j) will be published in the future as a need arises.