An Equitable Answer to Interest Expense Limitation In Massachusetts

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In this article, the authors argue that Massachusetts should apply the interest expense limitation on a combined-group basis and that guidelines for doing so may be based on Department of Revenue regulations regarding charitable contribution deductions.

Each change wrought by federal tax reform creates uncertainties and unintended consequences at the state level as states try to graft these changes onto their existing corporate tax regimes. The new federal interest expense limitation is no different. In many states, it is unclear whether the federal interest expense limitation is tested on a separate-company or combined-group basis. Despite the significant impact this distinction can have on a corporate taxpayer's state income tax liability, many states have yet to issue guidance. Although Massachusetts is one of several states without specific interest expense limitation guidance, the answer on how the limitation is tested may already be in regulations promulgated by the Department of Revenue.

New Internal Revenue Code section 163(j) limits a taxpayer's interest expense to the sum of business interest income, 30 percent of adjusted taxable income (generally, taxable income before net operating loss, business interest, and depreciation), and floor plan financing interest.[1] The IRC requires taxpayers to compute the limitation on an entity-by-entity basis. While Treasury regulations applicable to taxpayers electing to file a consolidated federal return require taxpayers to compute the limitation on a consolidated-group basis, most states do not conform to these regulations.[2] Thus, a mechanical application of the law in states that do not conform to the regulations generally

[1] IRC section 163(j)(1), (8). The new limitation is effective for tax years beginning after December 31, 2017, and does not apply to all taxpayers (*e.g.*, businesses with average gross receipts of less than $25 million over the prior three years). Section 163(j)(3). For tax years beginning after December 31, 2021, ATI reflects depreciation, so section 163(j) will potentially affect more taxpayers. Section 163(j)(8).

[2] Prop. reg. section 1.163(j)-4(d).

requires a taxpayer to follow the IRC and test the limitation on a separate-company basis — even if the state has adopted combined reporting.

There is no sound policy justification for applying this mechanical, separate-company testing approach — a method that is often detrimental to taxpayers. This is especially true in states that require combined reporting. The same rationale that applies at the federal level to test the limitation on a consolidated-group basis applies at the state level to test the limitation on a combined-group basis. That is, there is no reason to prevent deductible interest payments among members of the consolidated or combined group when their income is combined in computing the tax base.

There is also little reason to apply section 163(j) in separate-company states that have enacted an interest addback regime. This is because the legislatures in these states have already considered the problem of base erosion through deductible interest payments, considered alternatives, and enacted a solution to combat the problem. Piling the section 163(j) limitation onto these states' existing addback mechanisms creates unintended complexities and is arguably contrary to legislative intent.

Some practitioners have argued that there is no policy justification for section 163(j) to apply in any states that do not allow taxpayers to claim bonus depreciation. This argument views the primary purpose of section 163(j) as preventing double deductions when a taxpayer borrows money to purchase an asset, deducts interest expense on the loan, and claims 100 percent bonus depreciation on the purchased asset. There is some support for this view: Congress allows some taxpayers such as real estate companies to elect out of section 163(j). But a taxpayer that elects out of section 163(j) must depreciate its assets using the straight-line method over the life of the property.[3]

Perhaps in recognition of some or all these policy justifications, several states have either decoupled from section 163(j) entirely,[4] or issued guidance allowing taxpayers to apply aspects of the federal consolidated-group interest expense limitation rules.[5]

As of this writing, Massachusetts has not issued guidance. Although the state requires taxpayers to file on a combined-group basis, a mechanical application of Massachusetts law may require taxpayers to compute the interest expense limitation on a separate-company basis.[6] Moreover, the interaction between Massachusetts's comprehensive addback regime and section 163(j) is unclear.

However, the DOR's regulations on the federal charitable deduction provide a framework to apply the limitation on a combined-group basis. Applying that framework also would solve the problems of carrying forward disallowed interest expense and the interaction between the limitation and Massachusetts's interest addback.

Applying the Charitable Deduction Regulation to The Interest Expense Limitation

One way to interpret Massachusetts statutes and regulations would be to require a corporation filing as part of a combined return to apply the interest expense limitation on a separate-company basis. This is because the taxable income of a Massachusetts combined group is "the sum of the incomes, separately determined, of each member of the combined group."[7] This interpretation may result in more of a taxpayer's interest expense being disallowed and would be administratively burdensome for taxpayers and the DOR. Another interpretation — and the better answer from a policy and administrative perspective — would be to apply the limitation on

[3] Section 163(j)(10); and section 168(g)(1)(F).

[4] *See, e.g.*, 2017 Wisconsin Act 231 (Apr. 3, 2018); and H.B. 918, Reg. Sess. (Ga. 2018).

[5] *See, e.g.*, Pennsylvania Corp. Tax Bulletin 2019-03 (Apr. 29, 2019) (no separate-company limitation applies if taxpayer is a member of a federal consolidated group that does not have a limitation); and New Jersey TB-87 (Apr. 12, 2019) (limitation computed at federal consolidated or combined-group level, allocated to members under consolidated-group regulations).

[6] Mass. Gen. Laws 63 c, sections 31J, 31K; and 830 Mass. Code Regs. section 63.32B.2(6)(c)1 ("the total income of the combined group is the sum of the incomes, separately determined, of each member of the combined group.").

[7] 830 Mass. Code Regs. section 63.32B.2(6)(c)(2); *see also* Mass. Gen. Laws ch. 63, section 32B(d)(3). *FMR Corp. v. Commissioner*, 441 Mass. 810 (2004) ("the plain language of G.L. c. 63, section 32B . . . requires net income to be calculated on an individual-entity basis.") (obsoleted in part by amendments to Mass. Gen. Laws ch. 63 section 32B and 830 Mass. Code Regs. section 63.32B.2(6)(c)(6)).

a combined-group basis. There is precedent in DOR regulations for this approach.

The existing federal limitation on the deductibility of charitable contributions is like the new interest expense limitation. IRC section 170 limits the charitable contribution deduction to 10 percent of the corporation's taxable income.[8] Similarly, section 163(j) limits the interest expense deduction of a corporation that is not part of a federal consolidated group to 30 percent of the corporation's ATI. Recognizing that it is inappropriate to test both limitations on a separate-company basis in computing the taxable income of corporations filing as part of a consolidated group, Treasury regulations require taxpayers to compute the limitations on a consolidated-group basis.[9]

In 2009 Massachusetts adopted a similar approach regarding the charitable contribution deduction limitation.[10] The regulation requires a taxpayer to compute the limitation on a combined-group basis, then allows each member to take a pro rata portion based on each member's proportionate share of the group's charitable contributions. The regulations also provide that any disallowed charitable contribution deduction is carried forward by individual group members rather than on a group level. So, if a member leaves the group, the member takes any charitable contribution carryforward with it.

The DOR could adopt similar rules for the section 163(j) interest expense limitation. Applying the limitation on a combined-group basis would, like the charitable deduction rule, produce a more equitable result for taxpayers. Consider Corporations A and B, who are engaged in a unitary business for the 2018 tax year and will be required to file a combined return. A and B have no interest income, $40,000 and $10,000 of ATI, respectively, and incur interest expense of $5,000 and $7,500, respectively.

As seen in Table 1, if the section 163(j) interest expense limitation applies to A and B on a separate-entity basis, Company A would be able to deduct all its interest expense because its interest expense ($5,000) is less than 30 percent of its ATI (30% x $40,000 = $12,000). On a separate-entity basis, Company B would be allowed to deduct only $3,000 of its $7,500 of interest expense because its interest expense would be limited to 30 percent of its ATI (30% x 10,000 = $3,000). Thus, if the section 163(j) interest expense limitation is calculated on a separate-entity basis, the A-B combined group would be able to deduct only $8,000 of its $12,500 of interest expense. The group would lose out on $4,500 of interest expense deductions for the 2018 tax year.[11]

If, however, the A-B combined group could calculate its interest expense limitation on a combined-group basis, the group would be allowed to deduct all $12,500 of its interest expense. This is because the combined section 163(j) limitation would be $15,000, 30 percent of the combined group's ATI (30% x $50,000).

Table 1. Separate Versus Combined Limitation

	Corp. A	Corp. B	Total
Adjusted taxable income	$40,000	$10,000	$50,000
Interest expense	$5,000	$7,500	$12,500
Allowed interest expense			
Determined on separate-company basis	$5,000	$3,000	$8,000
Determined on combined-group basis	$5,000	$7,500	$12,500

We understand that the DOR is drafting regulations addressing the application of the interest expense limitation for corporate excise tax purposes. Because this limitation presents problems like the charitable deduction limitation, the DOR should consider adopting a rule like that adopted for the charitable deduction limitation, applying the limitation on a combined-group basis.

The DOR considered applying the charitable deduction rule to the pre-Tax Cuts

[8] Section 170(b)(2)(A).

[9] Reg. sections 1.1502-11(a)(5), 1.1502-24(a) (charitable donation deduction); and prop. reg. section 1.163(j)-4(d).

[10] 830 Mass. Code Regs. section 63.32B.2(6)(c)(6).

[11] Company B would be permitted to carry over the remaining $4,500 of interest expense into future years.

and Jobs Act version of section 163(j) when drafting Massachusetts's combined-reporting regulations. Internal correspondence between DOR officials considered whether the group computation of the charitable deduction should be broadened to include "other limitations based on income," including section 163(j). The regulatory file is unclear as to why the regulation's final version did not adopt the proposal to broaden it.

Interest Expense Limitation and Addback

A Massachusetts interest expense limitation regulation that follows the model of the charitable deduction regulation would also answer how section 163(j) intersects with the interest expense addback. Although the addback generally does not apply to interest payments between members of a Massachusetts combined group, the interplay between section 163(j) and addback continues to be relevant for taxpayers paying interest to foreign affiliates outside the combined group.

If the DOR models its interest expense limitation rules on the existing charitable deduction rule, taxpayers would be required to apply the interest expense addback before the interest expense limitation. This is because the related-party interest addback would remain a separate-company calculation performed before the calculation of the combined group's net income.[12] But the interest expense limitation would be computed at the combined-group level — after addback.[13]

Applying the related-entity addback before the limitation will generally produce a better result for taxpayers than applying section 163(j) before addback. Consider Corporation C, which has $20,000 of ATI and $10,000 of interest expense. The interest expense is attributable in equal amounts to two different loans — one third-party, and one related-party, and no exception to addback applies.

As seen in Table 2, if the interest expense limitation were to apply before addback, section 163(j) would limit the interest expense to $6,000 (30% x $20,000 ATI). The DOR could then take the position that all of the disallowed interest expense is third-party and add back $5,000 of interest expense. In this case, Corporation C's total allowed interest expense would be $1,000 ($6,000 of allowable interest expense under 163(j) minus $5,000 of interest subject to addback). Alternatively, the DOR could treat the section 163(j) limitation as applying partially to related-party and partially to third-party interest. In that case, the $6,000 limitation would be allocated so that the amount of related-party interest expense after section 163(j) would be $3,000 (50% of the $6,000 limitation). Corporation C's allowed interest expense would be $3,000 ($6,000 allowed after section 163(j) minus $3,000 of the remaining expense treated as related-party).

Table 2. Apply 163(j) Then Addback

Apply 163(j) to Third-Party Interest First		Apply 163(j) to Third/ Related-Party Interest Pro Rata	
Interest expense	$10,000	Interest expense	$10,000
Disallowed by 163(j)	($4,000)	Disallowed by 163(j)	($4,000)
	$6,000		$6,000
Addback	($5,000)	Addback	($3,000)
Allowed interest expense	$1,000	Allowed interest expense	$3,000

Conversely, if addback were to apply before the section 163(j) interest expense limitation, Corporation C could deduct $5,000 of interest expense. This is because after adding back the $5,000 of interest from the related-party loan, Corporation C would be allowed to deduct $5,000 of interest expense. Because Corporation C's section 163(j) limitation is $6,000, it would be able to deduct the entire $5,000 of interest expense remaining after addback.

[12] Mass. Gen. Laws ch. 63, section 31I(b) ("For purposes of computing its net income under this chapter, a taxpayer shall addback otherwise deductible interest expenses . . . directly or indirectly paid, accrued or incurred to . . . one or more related members."); Mass. Gen. Laws ch. 63, sections 31J, 31K; and 830 Mass. Code Regs. section 63.32B.2(6)(c)1.

[13] 830 Mass. Code Regs. section 63.32B.2(6)(c)(6), Example ("The 10% Code section 170 income limitation to be applied to a charitable expense deduction is applied to the combined group's taxable income.").

Table 3. Apply Addback Then 163(j)

Interest Expense	$10,000
Addback	($5,000)
	$5,000
Disallowed by 163(j)	-
Allowed interest expense	$5,000

Applying addback before the section 163(j) limitation would be consistent with the purpose of both steps. The purpose of addback is to prevent state tax base erosion. The Massachusetts legislature recognized this problem and enacted the related-entity interest expense addback statute to address it. Conversely, the legislature has never specifically adopted section 163(j) or considered its policy objectives. Given the inherent conflict between addback and section 163(j), the policy-driven solution adopted by the legislature should be given deference over the new section 163(j).

DOR officials may disagree, recently stating that whereas addback targets debt that is not bona fide (e.g., lacks economic substance and business purpose), section 163(j) seeks to prevent base erosion that occurs from the use of bona fide debt.[14] Under this view, because the policy objectives of addback and section 163(j) are distinct, there is no reason to give addback preference over section 163(j).

Massachusetts has not adopted guidance addressing section 163(j). Adopting the same rule that applies to the charitable contribution limitation, and clarifying that addback applies before section 163(j), would create a regime that is most faithful to the legislature's intent, easy to administer, and generally taxpayer-friendly. ■

[14] *See* Amy Hamilton, "Fatale Urges New State Take on Interest Deduction Limits," *State Tax Notes*, May 20, 2019, p. 698.