# Business Interest Limitation Working Group Meeting

May 20, 2019

# Meeting Agenda

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- Purpose of the Meeting
- Federal Business Interest Limitation
- Tax Filings by Affiliated Groups
- Issue: Computing the Limitation for State Purposes
- Plan for the Guidelines
- Questions and Open Discussion

# Purpose of this Meeting

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## Budget Language Requiring Study and Guidelines

- Item 272(E) of the 2019 Appropriation Act (House Bill 1700) requires the Tax Commissioner to convene a working group by June 1, 2019 to study the impact of the limitation of interest expense on businesses that are part of an affiliated group and file a Virginia combined or consolidated return
- Also requires the Tax Commissioner to develop and make available guidelines regarding the determination of the limitation of interest expense under IRC § 163(j) by December 1, 2019
- Such guidelines will apply to taxable years beginning on or after January 1, 2018

# Federal Business Interest Limitation

## Section 163(j) Business Interest Limitation

- Prior to the Tax Cuts and Jobs Act ("TCJA") interest was generally deductible in the year paid or accrued
- The TCJA imposed a limitation on the deductibility of business interest
- This generally limits a taxpayer's deduction for business interest to the sum of:
  - The taxpayer's business interest income for the taxable year;
  - 30% of the taxpayer's adjusted taxable income ("ATI"); and
  - The taxpayer's floor plan financing for the taxable year
- Business interest expense that is disallowed may be carried forward and deducted indefinitely
- Limitation is effective for taxable years beginning after December 31, 2017

# Federal Business Interest Limitation



## Adjusted Taxable Income

- Adjusted taxable income ("ATI") is defined as the taxable income of the taxpayer without regard to:
  - Items of income, gain, deduction or loss not allocable to a trade or business;
  - Any business interest or business interest income;
  - Any net operating loss deduction;
  - Any "pass-through" deduction under IRC § 199A; and
  - For taxable years commencing prior to January 1, 2022, any depreciation, amortization or depletion deductions

# Federal Business Interest Limitation



## Exceptions from Business Interest Limitation

- The business interest limitation does not apply to:
  - A taxpayer that has annual gross receipts for the three-taxable-year period ending with the prior taxable year equal to or less than $25 million (“the small business exception”);
  - An electing real property trade or business;
  - An electing farming business;
  - Certain trades or businesses of regulated public utilities; and
  - The trade or business of providing services as an employee

# Federal Business Interest Limitation



## Proposed Regulations under IRC § 163(j)

- The Treasury Department released proposed regulations on November 26, 2018 relating to the IRC § 163(j) business interest limitation
- Proposed regulations provide that a federal consolidated group would have a single business interest limitation based upon the group's ATI calculated on a consolidated basis, and are treated as a single entity for computing the business interest limitation
- In the calculation of the consolidated group's limitation, intercompany obligations between members of the same consolidated group are disregarded for purposes of determining business interest expense and business interest income

# Federal Business Interest Limitation



## Conformity Legislation Enacted During 2019 Session (HB 2529/SB 1372)

- During the 2019 Session, legislation was enacted that generally conforms Virginia to the provisions of the TCJA, including the new limitation on business interest
- The starting point for the determination of Virginia taxable income is federal taxable income for corporations and federal adjusted gross income for individuals
- Because the interest deduction is a component of federal taxable income and federal adjusted gross income, any reduction to the federal interest deduction under the business interest limitation will flow from the federal onto the Virginia return

# Tax Filings by Affiliated Groups

# Tax Filings by Affiliated Groups



## Federal Filing Status

- For federal income tax purposes, an affiliated group of corporations has the option of filing a consolidated return in lieu of separate returns
- The affiliated group members are treated as one entity and their financial activities are combined for purposes of computing their federal income tax liability
- For federal purposes, a corporation meets the requirements for affiliation if it possesses at least 80% of the total voting power and at least 80% of the total value of a corporation’s stock

# Tax Filings by Affiliated Groups



## Virginia Filing Status

- Virginia allows an affiliated group of corporations with Virginia nexus to elect to file in the following ways regardless of how they file federally: (i) separately; (ii) consolidated; or (iii) using a Virginia combined return
- Virginia affiliated groups may differ from federal affiliated groups because each member of a group is only affiliated for Virginia purposes if it has nexus with the state
- A group of two or more corporations is an “affiliated group” if:
  - A corporation owns at least 80% of the voting stock of the other(s); or
  - At least 80% of the voting stock of two or more of the corporations is owned by the same interests

# Tax Filings by Affiliated Groups



## Virginia Filing Status – Separate Return

- If an affiliated group of corporations elects to file separately, each corporation in the affiliated group that has nexus in Virginia is required to file its own separate corporate income tax return and report only its income, expenses, gains, losses, and allocation and apportionment factors on such return
- This type of reporting follows the separate entity concept, in which each corporation in an affiliated group is treated as distinct and separate from the other corporations in such group for purposes of determining each corporation's corporate income tax liability

# Tax Filings by Affiliated Groups



## Virginia Filing Status – Consolidated Return

- A consolidated return includes the aggregate income, expenses, gains, and losses, allocation and apportionment factors of all of the corporations in an affiliated group that have nexus with Virginia
- The corporate income tax liability of the affiliated group is computed in the aggregate, and the entire affiliated group files one corporate income tax return

# Tax Filings by Affiliated Groups



## Virginia Filing Status – Virginia Combined Return

- In a Virginia combined return, each corporation in an affiliated group that has nexus with Virginia determines its income, expenses, gains, losses, and allocation and apportionment factors separately.
- Each corporation then separately computes its individual corporate income tax liability
- The final corporate income tax liability of each corporation is then combined and included on one corporate income tax return
- This is not the same as unitary combined reporting

# Computing the Limitation for State Purposes

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## Computing the Limitation for Virginia Purposes

- Virginia affiliated groups often consist of a different group of corporations than a federal affiliated group because of differing rules for what corporations are included in the group
- In addition, Virginia allows an affiliated group to elect to file a Virginia combined or consolidated return regardless of how they filed federally
- This requires an affiliated group that opts to file a Virginia combined or consolidated return to compute the business interest limitation solely for Virginia purposes based on the corporations in the Virginia affiliated group
- For Virginia combined filers, this would also require each corporation to separately compute the business interest limitation

# Computing the Limitation for State Purposes



## Business Interest Limitation and Other States

- NJ has released guidance treating members of the NJ combined group as one entity for purposes of computing the business interest limitation
- Pennsylvania has released guidance indicating that corporations are required to separately compute the business interest limitation, even if they were part of a federal consolidated return.  However, Pennsylvania does not allow for state combined or consolidated reporting
- Neither the MTC nor any other similar group has indicated that it would form a work group and release model guidance on this issue

# Computing the Limitation for State Purposes



## Other Virginia-Specific Issues

- As part of Virginia's 2019 conformity legislation, the General Assembly authorized an individual and corporate income tax deduction equal to 20% of interest disallowed for federal purposes under the business interest limitation
- Virginia requires an addback for certain related member interest expenses when deductible for federal income tax purposes

# Plan for the Guidelines

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## Timeline for Guidelines

- Initial Working Group Meeting: May 20, 2019
- Initial Comment Period: May 20, 2019 through July 1, 2019
  - Please submit any comments you have regarding the guidelines to the Department by emailing such comments to James Savage at james.savage@tax.virginia.gov
- Draft guidelines will be circulated following the initial comment period for additional feedback
- Final guidelines will be published by December 1, 2019

# Questions and Open Discussion