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Primer: Internal Revenue Code Section 163(j)

A Brief Guide on Decoupling from IRS 163(j)

Given the recent attention to the issue of whether Massachusetts should decouple from Internal Revenue Code Section 163(j), the Massachusetts Taxpayers Foundation (MTF) has assembled a brief primer on the issue explaining what the provision does, why it is necessary, likely impacts, and cost implications.

Background

Federal Tax Reform & Massachusetts

The Tax Cut and Jobs Act (TCJA) implemented a new, more competitive territorial tax regime in the United States that reduced the federal corporate income tax rate to 21 percent while broadening the tax base.

Among the many changes included in TCJA were two related provisions that limited the deductibility of interest expense (IRC § 163(j)) while allowing 100 percent bonus depreciation (IRC § 168(k)). The Congress intended these provisions to work in tandem to encourage companies to invest repatriated profits in the US economy.

The integrated federal tax policy will play out differently as it interacts with the Massachusetts tax code. While Massachusetts automatically conforms to the Internal Revenue Code generally for the purpose of the corporate tax code, the legislature chose to decouple with respect to bonus depreciation many years prior to enactment of TCJA. Adhering to IRC § 163(j) without also adhering to IRC § 168(k) means that Massachusetts will both limit business interest expense *and* continue not to allow for bonus depreciation. This would have the unintended net effect of raising the cost of capital in the Commonwealth, increasing taxes on Massachusetts employers and leaving fewer resources available for hiring, expansion, and business process improvements.



Several other states have already taken action to address this issue. Alabama, Connecticut, Georgia, Indiana, Missouri, South Carolina, Tennessee, and Wisconsin have decoupled from IRC § 163(j). Notably, California did not adopt IRC § 163(j).

Legislative History

The §163(j) issue was raised in 2018 when tax practitioners analyzed the impacts of federal tax reform. Legislation was filed at the beginning of the session to address the issue (H.2606). A hearing was held on June 11, 2019 and the Committee indicated it was inclined to report the bill out favorably. Further, a coalition of taxpayers reached out to DOR to discuss when guidance would be issued on the subject in the spring of 2019 while simultaneously holding meetings with several legislators to brief them on the issue and indicate the need for a legislative solution rather than regulatory guidance.

Some advocates have suggested a reform of this type should be studied by the Senate Revenue Working Group before any further action, but this approach would be misguided. Failure to act would represent a significant change in tax policy that would be neither deliberate nor timely. While the Working Group determines if a change in the tax treatment of interest expense is warranted, lawmakers should preserve the historic deductibility of interest expense as an interim approach.

Recognizing the time sensitive nature of the necessary changes, Governor Charlie Baker included provisions to decouple Massachusetts from IRC § 163(j) in his fiscal 2019 supplemental appropriations bill (H.4067). The House of Representatives included these provisions in their appropriations bill (H.4127). The Senate did not include the items in their bill approved on October 24, 2019.

Policy Implications

Filing Deadline Urgency

The 163(j) issue is urgent for many corporate taxpayers impacted by the change. Tax returns for tax year 2018 are due no later than November 15, 2019. These employers need guidance on how to complete their returns.

While the Massachusetts Department of Revenue (DOR) issued a draft technical information release in early October, taxpayers are struggling to understand the guidance and, more fundamentally, the guidance does not resolve the key issues and



challenges involved in overlaying a complex federal tax provision onto the Massachusetts corporate tax code.

Potential Foregone Revenue

DOR has estimated the cost of decoupling from IRC § 163(j) in a range between \$28 million and \$46 million in fiscal 2020 with a midpoint estimate of \$37 million. It is important to note, however, that decoupling will not result in lower tax collections than fiscal 2019. Rather, this change would prevent the collection of revenue that has not previously been collected. The cost of restoring the full interest expense deduction will be offset by increased corporate tax collections Massachusetts has experienced as a result of federal tax reform more broadly. Notably, the DOR estimate does not reflect the capital investment that Massachusetts may lose as a result of this unintentional policy change.

Recommendation

The clearest and simplest way to address the issue is to decouple from IRC § 163(j) in order to simplify compliance, reduce audit disputes, and minimize unnecessary tax litigation.

By including these provisions in the final version of the supplemental appropriations bill, policymakers will be preserving the Massachusetts tax treatment of interest expense that has long existed in the Commonwealth. Conversely, by not decoupling, policymakers would be effectively imposing a corporate tax increase and increasing the cost of capital for affected taxpayers.

