

May 29, 2019

Advisory Notice – Net Interest Expense Limitation [IRC Sec. 163(j)] Tax Policy Update

How does the City of Philadelphia treat the federal interest expense limitation for the Business Income and Receipts Tax (BIRT)?

Answer:

- For BIRT Method II taxpayers, net income shall be the portion of the taxpayer's adjusted taxable income (or loss) from any business activity as properly returned to and ascertained by the Federal Government, prior to giving effect to the exclusion for dividends received and for net operating losses, which is apportioned to Philadelphia, plus the taxpayer's nonbusiness income which is allocated to Philadelphia.¹
- Absent Pennsylvania legislation decoupling a taxpayer's federal interest expense deduction amount for Philadelphia BIRT purposes, taxpayers are obligated to use the federal interest expense deduction calculated on a separate entity basis.
- Taxpayers are not required or permitted to participate in the filing of a consolidated or combined BIRT return.² For taxpayers that file a consolidated federal return, if the consolidated group reports an interest limitation under Section 163(j), then each member of the consolidated group with a BIRT filing requirement must calculate its applicable federal interest expense limitation on a separate entity basis.
- To the extent practicable, the proposed federal regulations are to be followed in determining a taxpayer's pro-forma interest expense deduction under Section 163(j) for purposes of calculating BIRT Method II net income.
- To the extent a BIRT Method II taxpayer has a Section 163(j) limitation and also reports nonbusiness (allocable) income, the taxpayer should determine the amount of overall interest expense associated with nonbusiness income, if any, and allocate an interest limitation to that amount on a pro-rata basis.
- For BIRT purposes, the interest expense limitation is calculated for partnerships at the partnership level.
- Because the Section 163(j) limitation is not reflected on a taxpayer's books and records, this adjustment would not be applicable to BIRT Method I taxpayers.

¹ BIRT Regulations – Section 404(A)

² Philadelphia Code § 19-2601 *Net Income* (b)

Federal Changes:

- Under new IRC Section 163(j) of the Tax Cuts and Jobs Act (TCJA), a taxpayer's business interest expense deduction for tax years beginning after December 31, 2017 is limited to the sum of:
 - The taxpayer's business interest income;
 - 30% of the taxpayer's adjusted taxable income; plus,
 - The taxpayer's floor plan interest.
- New Section 163(j) applies to all taxpayers, including partnerships and their partners.
- Taxpayers with average annual gross receipts of less than \$25 million are generally excluded from the application of Section 163(j).
- Any interest expense disallowed by Section 163(j) in one taxable year may be carried forward indefinitely.
- Proposed regulations issued on November 26, 2018 provide that the Section 163(j) limitation applies at the consolidated return level. A consolidated group calculates a single interest expense limitation.