

Guidelines Regarding the Business Interest Limitation

During the 2019 Session, the Virginia General Assembly enacted budget language (Item 272(E) of the 2019 Appropriation Act (House Bill 1700, Chapter 854)) that requires the Department of Taxation (“the Department”) to publish guidelines regarding how taxpayers are required to account for the Internal Revenue Code (“IRC”) § 163(j) federal limitation on the deductibility of business interest (“the business interest limitation”) for Virginia income tax purposes. This also requires the Department 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. On May 20, 2019, the Department held a working group meeting and solicited comments from affected parties regarding the application of this limitation for Virginia income tax purposes.

These guidelines are published by the Department to provide guidance to taxpayers regarding the determination of the federal business interest limitation, as required by Item 272(E) of the 2019 Appropriation Act. These guidelines are not rules or regulations subject to the provisions of the Administrative Process Act (*Va. Code* § 2.2-4000 et seq.) and are being published in accordance with the Tax Commissioner’s general authority to supervise the administration of the tax laws of the Commonwealth pursuant to *Va. Code* § 58.1-202. As necessary, additional information will be published and posted on the Department’s website, www.tax.virginia.gov.

These guidelines complement the Department’s existing Individual Income Tax Regulation (23 *Virginia Administrative Code* (“VAC”) 10-110-20 et seq.) and Corporation Income Tax Regulation (23 VAC 10-120-10 et seq.). To the extent that there is a conflict between the Department’s existing guidance and 2019 Acts of Assembly, Chapters 17 and 18, the provisions of those laws, as interpreted by these guidelines, supersede existing guidance.

These guidelines represent the Department’s interpretation of the relevant laws. They do not constitute formal rulemaking and hence do not have the force and effect of law or regulation. In the event that the final determination of any court holds that any provision of these guidelines is contrary to law, taxpayers who follow these guidelines will be treated as relying on erroneous written advice for purposes of waiving penalty and interest under *Va. Code* §§ 58.1-105, 58.1-1835, and 58.1-1845.

On November 26, 2018 the U.S. Department of the Treasury published proposed regulations regarding the business interest limitation. It is unclear when the final regulations will be published and whether such regulations will include substantial changes. Because of uncertainties regarding these regulations, the Department has refrained from addressing the application of business interest limitation to individuals and pass-through entities at this time. The Department anticipates addressing such issues in future guidance.

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General Overview of the Business Interest Deduction

Federal Interest Deduction and Business Interest Limitation

Prior to the enactment of the Tax Cuts and Jobs Act (“the TCJA”), interest was generally deductible for federal income tax purposes in the year it was paid or accrued. On December 22, 2017, Congress enacted the TCJA, which included a provision that limited the deductibility of business interest for taxable years beginning after December 31, 2017. See IRC § 163(j). Under this limitation, the deduction for business interest for a taxable year generally may not exceed the aggregate of the following amounts:

- The taxpayer’s business interest income for the taxable year;
- 30 percent of the taxpayer’s adjusted taxable income (“ATI”) for the taxable year; plus
- The taxpayer’s floor plan financing for the taxable year.

Pursuant to IRC § 163(j)(8), ATI is defined as the taxable income of the taxpayer:

- Computed without regard to:
 - Any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
 - Any business interest or business interest income,
 - The amount of any net operating loss deduction under IRC § 172,
 - The amount of any deduction allowed under IRC § 199A, and
 - In the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and
- Computed with such other adjustments as provided by the Secretary of the Treasury.

Any business interest that is disallowed because of the business interest limitation is treated as business interest paid or accrued in the following taxable year, and may be carried forward indefinitely, subject to certain restrictions.

For additional information regarding the federal business interest limitation and any exceptions that may apply, please see IRC § 163(j), Prop. Treas. Reg. §§ 1.163(j)-1 through 1.163(j)-11, and www.irs.gov.

Virginia Treatment of Interest Deduction and Business Interest Limitation

During the 2019 Session, the General Assembly enacted legislation that generally conforms Virginia to the TCJA, including the limitation on the deductibility of business interest. See House Bill 2529 (2019 *Acts of Assembly*, Chapter 17) and 2019 Senate Bill 1372 (2019 *Acts of Assembly*, Chapter 18). Therefore, the limitation applies for Virginia income tax purposes to the extent a taxpayer’s deduction for business interest is limited

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on its federal income tax return and such deduction impacts federal adjusted gross income (“FAGI”) for individuals or federal taxable income (“FTI”) for corporations. Taxpayers that do not claim a federal deduction for business interest or are provided an exception are not subject to the limitation for Virginia income tax purposes.

Because the deduction for interest is allowed as a component of FAGI or FTI, taxpayers may carry forward and deduct business interest for Virginia income tax purposes. A taxpayer that becomes subject to Virginia income tax will receive the tax benefit of reduced FAGI or FTI from an interest deduction carryforward claimed on its federal return, even if the taxpayer was not subject to Virginia income tax during the prior year in which the interest expense was paid or accrued. Similarly, a taxpayer that is no longer subject to Virginia income tax will not receive the tax benefit attributable to any business interest that is in excess of the business interest limitation and that is carried forward to a year when the taxpayer is not subject to Virginia income tax, even if the taxpayer was subject to Virginia income tax during the prior year in which the interest expense was paid or accrued.

In addition, Virginia allows a corporate and individual income tax deduction equal to 20 percent of the amount of business interest that is disallowed as a deduction for federal income tax purposes pursuant to the business interest limitation. This will accelerate the deduction of business interest for Virginia income tax purposes by allowing a larger deduction during the year in which interest expense is paid or accrued than is allowed on the federal return. However, in future taxable years, taxpayers will be required to reconcile this acceleration on their Virginia income tax returns. The Department will publish more information regarding this process in upcoming form instructions.

Virginia Corporate Filings and the Business Interest Limitation

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

Virginia Code § 58.1-442 allows members of an affiliated group of corporations with Virginia nexus to elect to file on the following bases regardless of how they file federally:

- Separately;
- Consolidated; or
- Using a Virginia combined return.

A corporation generally meets the Virginia requirements for affiliation if each corporation included in the group is itself subject to Virginia income tax and if:

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- A corporation owns at least 80 percent of the voting stock of the other(s); or
- At least 80 percent of the voting stock of two or more of the corporations is owned by the same interests.

Virginia affiliated groups may differ from federal affiliated groups primarily because each corporation in the group must have nexus with the state and the members in a Virginia affiliated group may elect to file on a different bases than how they opted to file federally. If a Virginia affiliated group files its federal and Virginia returns on a different basis, included different members in its filings, or both, then FTI must be re-computed. Re-computed FTI must be used to determine the amount of deductions allowable for the current year, the amount of deductions to be carried forward to future years, and the amount of deduction carryforwards to be used in such future years. See 23 VAC 10-120-320 through 23 VAC 10-120-326. Virginia has consistently applied this treatment to federal deductions with carryforwards, including the federal charitable contribution deduction and the federal net operating loss deduction.

Virginia Code § 58.1-442 and 23 VAC 10-120-320 through 23 VAC 10-120-326 also apply to the federal deduction for business interest and its 30 percent annual limitation. In particular, if the affiliated group files a consolidated Virginia return, see 23 VAC 10-120-320(D)(1)(a).

Example 1 . An affiliated group of five corporations has filed a consolidated federal return. In Year 1, the affiliated group has \$100 of ATI and \$40 of business interest expense. In Year 1, the affiliated group’s business interest limitation is 30 percent of its ATI, or \$30 (\$100 x 30 percent), as shown below:

	CONSOL	A	B	C	D	E
ATI	100	20	20	20	30	10
Limitation	30	--	--	--	--	--
Business Interest Expense	40	3	3	25	6	3
Deductible Business Interest	30	--	--	--	--	--
Carryforward	10	--	--	--	--	--

Thus, the affiliated group has \$30 of deductible business interest expense and \$10 of carryforward.

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During Year 1, none of these corporations had fixed date conformity modifications, and A, B, C, and E were subject to tax in Virginia. D was not subject to tax in Virginia. If the group elects to file a consolidated Virginia return, the affiliated group's business interest limitation is 30 percent of its ATI, or \$21 (\$70 x 30 percent), as shown below:

	CONSOL	A	B	C	E
ATI	70	20	20	20	10
Limitation	21	--	--	--	--
Business Interest Expense	34	3	3	25	3
Deductible Business Interest	21	--	--	--	--
Carryforward	13	--	--	--	--

Thus, it has \$21 of deductible business interest expense and \$13 of carryforward.

If the affiliated group files a separate or Virginia combined return, see 23 VAC 10-120-320(D)(b)-(c), as applicable.

Example 2. Same as Example 1, but assume that the group elects to file separate Virginia returns. If so, each corporation would compute its separate business interest limitation, separate deductible business interest expense, and separate carryforward amount, as shown below:

	TOTAL	A	B	C	E
ATI	--	20	20	20	10
Limitation	--	6	6	6	3
Business Interest Expense	--	3	3	25	3
Deductible Business Interest	15	3	3	6	3
Carryforward	19	0	0	19	0

Note that the total in the "TOTAL" column is provided for convenience. There is no consolidation or combination for Virginia separate return filers.

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Example 3. Same as Example 2, but assume that the group elects to file a Virginia combined return. If so, the amount reported as the separate deductible business interest for each affiliate (for purposes of the combined return) is deemed to be computed as if separate federal returns were filed for each corporation. The years to which deductible business interest are carried and the amounts used each year for Virginia purposes are deemed to be computed as if separate federal returns were filed, regardless of the type of federal returns actually filed in the carryover year. Thus, A has \$3 of deductible business interest expense and no carryforward, B has \$3 of deductible business interest expense and no carryforward, C has \$6 of deductible business interest expense and \$19 of carryforward, and E has \$3 of deductible business interest expense and no carryforward.

Fixed Date Conformity Modifications

While Virginia generally conforms to the IRC, there are specific exceptions. Virginia deconforms from (1) bonus depreciation allowed for certain assets under federal income taxation; (2) five-year carry back of certain net operating losses (“NOLs”) generated in Taxable Years 2008 and 2009; (3) tax exclusions related to cancellation of debt income; and (4) tax deductions related to the application of the applicable high yield debt obligation rules. These are referred to as “fixed date conformity modifications.” Fixed date conformity modifications are not considered to be Virginia modifications. Rather, these exceptions identified in *Va. Code* § 58.1-301 are added to or subtracted from a corporation’s FTI as computed under the IRC in order to determine its FTI for Virginia income tax purposes.

To the extent that a corporation is subject to fixed date conformity modifications, it must re-compute its FTI and ATI for Virginia purposes before determining its business interest limitation for Virginia purposes. The formula for determining FTI for Virginia purposes (“Virginia FTI”) is as follows:

$$\text{FTI +/- Fixed date conformity modifications} = \text{Virginia FTI}$$

Adjusted taxable income for Virginia purposes (“Virginia ATI”) equals Virginia FTI plus the net of:

- Any additions required by IRC § 163(j)(8) or the regulations thereunder to the extent otherwise excluded or deducted in computing Virginia FTI, and
- Any subtractions required by IRC § 163(j)(8) or the regulations thereunder to the extent included in and not otherwise subtracted in computing Virginia FTI.

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A corporation's business interest limitation for Virginia purposes will equal the sum of business interest income, 30 percent of Virginia ATI, and floor plan financing interest. Similar re-computations must be made to FAGI for individuals.

Example 4. Corporation A has filed a federal return for Taxable Year 2018 reporting \$900 of FTI, including \$110 in depreciation deductions, \$100 of which is attributable to bonus depreciation. On its Virginia return, Corporation A has only \$10 in depreciation deductions because Virginia does not conform to bonus depreciation. To reflect the difference in its federal and Virginia depreciation deduction amounts, Corporation A reports a fixed date conformity addition of \$100 ($\$110 - \$10 = \100), and Virginia FTI of \$1,000 ($\$900 + \100).

Because IRC § 163(j)(8)(v) authorizes taxpayers to addback depreciation deductions in computing ATI, Corporation A has ATI of \$1,010 ($\$900 + \110), and a business interest limitation of \$303 ($\$1,010 \times 30$ percent). For Virginia purposes, Corporation has Virginia ATI of \$1,010 ($\$1,000 + \10), and a business interest limitation of \$303.

Example 5. Same as Example 4, except that the taxable year is 2022. Because IRC § 163(j)(8)(v) does not apply in the case of taxable years beginning on and after January 1, 2022, Corporation A may not addback depreciation deductions in computing its ATI. This means that, for federal purposes, Corporation A will have ATI of \$900 ($\$900 + \0), and a business interest limitation of \$270 ($\900×30 percent). However, for Virginia purposes, Corporation A will have Virginia ATI of \$1,000 ($\$1,000 + \0), and a business interest limitation of \$300 ($\$1,000 \times 30$ percent).

Additional Information

These guidelines are available online on the Virginia Regulatory Town Hall website, located at <https://townhall.virginia.gov>, and on the Guidance Documents section of the Department's website, located at <http://tax.virginia.gov/guidance-documents>. For additional information, please contact the Department at (804) 367-8037.