

Michigan issues notice on the corporate income tax treatment of IRC 163(j)

Overview

On June 8, 2020, the Michigan Department of Treasury ("Department") issued Notice: Corporate Income Tax Treatment of the IRC 163(j) Business Interest Limitation¹ (the "Notice") addressing the computation of the business interest expense limitation ("BIEL") found under Internal Revenue Code ("IRC") section 163(j) for Michigan Corporate Income Tax ("CIT") purposes. The guidance discusses how the limitation from the Tax Cuts and Jobs Act ("TCJA"), which was recently modified by the Coronavirus Aid, Relief and Economic Security ("CARES") Act, affects Michigan's CIT, especially for unitary business groups ("UBG"s). This tax alert highlights some of the more notable takeaways from the Notice pertaining to the Michigan tax law treatment of 163(j), which include:

- For CIT purposes, 163(j) is to be calculated on a separate-entity basis for each member of a UBG, instead of applying the limitation at a consolidated level. The separate company federal taxable income ("FTI") of each member of the group, including the separate company 163(j) limitation is then aggregated to determine combined group income.
- For purposes of the CIT separate company 163(j) limitation, pro forma adjusted taxable income ("ATI")² should be computed without regard to bonus depreciation.
- A UBG member cannot use the carryforward or disallowed business interest expense ("BIE") or unused limit of another UBG member.

Federal Treatment of IRC 163(j)

IRC 163(j) provides that the deduction allowed for BIE for any tax year generally cannot exceed the sum of:

1. The taxpayer's business interest income for the tax year,
2. 50% of the taxpayer's ATI,
3. The taxpayer's floorplan financing interest (certain interest paid by vehicle dealers) for the tax year.³

Affiliates that elect to file a federal consolidated return calculate a single limitation under IRC 163(j) and apply it at the consolidated return level. For the 2019 and 2020 tax years, the CARES Act increases the ATI limitation to 50%.⁴ In addition, the CARES Act also allows taxpayers to elect to substitute 2019 ATI for 2020 ATI and permit taxpayers to elect out of the ATI limitation increase.⁵

Michigan Treatment of IRC 163(j)

Michigan conforms to the current IRC and has not decoupled from the BIEL of IRC 163(j).⁶ The CIT's starting point is a taxpayer's FTI, which includes the BIE, as limited by 163(j), the taxpayer deducted in the computation of its FTI. Michigan law requires each UBG member to calculate its income on a separate-company basis, as if no consolidated return had been filed.⁷ Accordingly, instead of following the federal limitation applied at a consolidated level, each UBG member must

¹ Michigan Department of Treasury Notice: Corporate Income Tax Treatment of the IRC 163(j) Business Interest Limitation (available [here](#))

² The ATI limitation for tax years beginning in 2019 or 2020 is 50%, subject to a taxpayer's election to use a 30% limit. For tax year 2020, a taxpayer may elect to use its 2019 ATI as the base in computing its 2020 ATI limit. IRC 163(j)(10). The ATI limit for tax year 2018 and tax years beginning after 2020 is 30%.

³ See generally, IRC 163(j).

⁴ Coronavirus Aid, Relief, and Economic Security Act, H.R. 748, 116th Cong. (2020) Sec. 2306.

⁵ *Id.*

⁶ MCL 206.607(6). Alternatively, a taxpayer may conform to the IRC in effect as of January 1, 2018, which would also include the same version of section 163(j).

⁷ MCL 206.691.

separately calculate a pro forma BIE. According to the Notice, a UBG member considers only its own business interest expense, business interest income, and ATI in determining its limitation for CIT purposes. Additionally, when calculating its pro forma limit, the Notice provides that a UBG member does not eliminate transactions with companies that were included in the federal consolidated return.

For CIT purposes, ATI means, in relevant part, the taxable income of the taxpayer computed without regard to any deduction allowable for depreciation, amortization, or depletion for taxable years beginning prior to January 1, 2022.⁸ In this context, allowable depreciation includes bonus depreciation under IRC 168(k). However, for purposes of the CIT, FTI is defined as though IRC 168(k) were not in effect.⁹ This means ATI is calculated without regard to bonus depreciation for taxable years prior to January 1, 2022. However, the Notice states that for tax years beginning after December 31, 2021, ATI should still be calculated **without regard to bonus depreciation** for purposes of computing pro forma BIEL.

Michigan requires transactions between members of a UBG to be eliminated from the corporate income tax base.¹⁰ As a result, a UBG member must eliminate the pro forma BIE attributable to transactions with other members of the UBG. If a member's pro forma BIE is limited, then that member should eliminate the pro forma BIE to the extent it was deducted in arriving at the pro forma FTI. Additionally, a UBG member that extends credit to another member must eliminate its interest income generated to the extent that it is included in that member's pro forma FTI. In situations where interest is paid to a UBG member and an outside lender, if a UBG member's pro forma business interest expense is limited by IRC 163(j), then the limit is attributed proportionately (using a fraction) to the different types of interest expense. The BIE attributed to fellow UBG members must be eliminated from the corporate income tax base.

Michigan requires each UBG member to report and track any Michigan carryforward of disallowed BIE. In keeping with the requirement to compute separate company income, the Notice provides that a **UBG member is not permitted to use the carryforward or disallowed BIE of another UBG member.**

Reasonable Cause Penalty Waiver

The Department shall waive penalties for a tax deficiency upon a showing of reasonable cause.¹¹ If there is a tax deficiency due to not calculating BIE correctly in accordance with Department guidance, and that is the only reason for the deficiency, then this Notice states that the Department will consider that as sufficient factual evidence of reasonable cause to justify waiver of penalty upon a taxpayer's request. The Notice is silent as to whether the guidance is retroactive, or prospective only in nature, however, the Notice appears to be explaining the Department's interpretation of existing Michigan law.

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⁸ IRC 163(j)(8).

⁹ MCL 206.607(1).

¹⁰ MCL 206.691, UBG eliminations are required *after* the UBG has reached its business income, which is arrived at *after* group-level pro forma FTI.

¹¹ MCL 205.24(2), (4).

External Multistate Tax Alert

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