Greater Boston Chamber of Commerce

POLICY BRIEF

Policy Brief: Change in Federal Tax Law Means Massachusetts Risks Penalizing Investment

The Tax Cut and Jobs Act of 2017 (TCJA) was the most significant change to federal tax laws in decades, particularly for the corporate tax system, but the impacts are not limited to the federal system. For states like Massachusetts that align their state tax laws with federal tax laws, the TCJA resulted in potentially major changes to the state tax base, impacting both the government and taxpayers. In some instances, however, selectively aligning the Massachusetts tax base to the federal tax base discourages investment in Massachusetts.

Massachusetts, like many other states, "couples" or "conforms" to the federal corporate tax code, meaning that the Massachusetts tax base generally tracks the federal tax base, although the state maintains its own separate tax rate. This is common practice for states because it makes compliance and administration easier. For some purposes, however, Massachusetts departs from the federal law, which is called "de-coupling." The state does this in situations where the federal law may have unintended consequences for Massachusetts taxpayers, among other reasons.

After TCJA: 163(j) Limits & Full Expensing

Although the most talked-about change in the TCJA was the federal corporate tax rate reduction from 35 percent to 21 percent, there were substantial changes to the federal corporate tax base as well. Some changes encourage business spending while reducing the corporate tax base – at least in the short term – such as those that allow taxpayers to immediately expense more of the cost of certain business property (also referred to as full expensing or 100 percent bonus depreciation). Other changes, by contrast, eliminated or limited corporate deductions.

One such change in the TJCA was to place limits on the deduction for interest that corporate taxpayers pay on their debt (section 163(j)).[1] In general, allowing businesses to deduct the cost of interest from their taxable base encourages businesses spending. Federal limits on interest expense weaken that incentive, but for the most part, the benefits of a lower federal tax rate and the ability to expense immediately most depreciable assets outweigh the negative.

From a tax policy perspective, the limit on interest deduction is closely linked to full expensing in the federal tax changes. By limiting the 163(j) interest deduction, taxpayers cannot take advantage of both

What is 163(j)?

It's a reference to the section of the federal tax code dealing with limits on interest deduction.

What's the interest deduction?

It's a deduction that corporate taxpayers can take for the costs of interest on their debt.

What's full expensing?

Full expensing, sometimes called 100 percent bonus depreciation, allows taxpayers to deduct the expense the entire cost of some business property right away. Otherwise, businesses have to deduct it in phases.

How do 163(j) limits and full expensing relate?

The two go hand-in-hand. If a taxpayer uses full expensing, then limiting the amount of deduction they can take for debt is important so they don't double up on deductions for the same investment.

How does Massachusetts approach the two?

Massachusetts couples with federal law on the 163(j) limits for interest deduction, but not on full expensing. Since these were designed to be implemented together, it means that taxpayers will now have to pay more to borrow and invest in the state.

[1] The deduction for interest paid is in section 163(j) of the Internal Revenue Code so it is often referred to simply as 163(j).

expensing the cost of an asset fully upfront and deducting the costs of interest for the debt they used to buy that asset.

However, Massachusetts only conforms to the federal limitation on interest expense, and not full expensing. This has the effect of increasing the state corporate tax base without any offsetting relief from the drag on corporate spending. As a result, investing in Massachusetts has become more expensive, and this could deter investment.

Effects of Increasing the Cost of Debt

Ensuring that businesses are not penalized for borrowing is important because borrowing is a normal part of operations, and it frequently results in additional investment or expansion. Debt is used to invest in new equipment, upgrade technology, make capital improvements, and assist with cash flow. These investments are direct forms of economic development because they create and retain jobs for Massachusetts residents.

Debt is also used to explore new business opportunities. Although small businesses are not generally subject to limitation on the deduction, larger employers still use debt to fund business lines that may not yet be profitable. With increased emphasis on innovation and the rapid pace of discovery in all areas of the economy, it is important to ensure that there is not a penalty on the capital businesses need to fund that work.

Lastly, companies use debt at times to serve as a funding bridge while they attempt to reorient or reinvent themselves. Often, the decision to borrow can be at a critical juncture when an employer decides whether to try to salvage a business or to close it. If the business is unable to deduct interest costs, borrowing becomes more expensive, which may influence the decision.

Massachusetts can avoid penalizing businesses for their investments by decoupling from the provision in TCJA that limits the deduction for interest (section 163(j)). In order to remain regionally and internationally competitive Massachusetts should act quickly to encourage investment by removing unintended limitations on the deduction for interest.

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