Pennsylvania
Department of Revenue

# CORPORATION TAX BULLETIN 2026-01

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## Effective for tax years beginning on or after January 1, 2025

## PENNSYLVANIA CORPORATE NET INCOME TAX TREATMENT OF IRC § 163(j)

### Overview

The Tax Cuts and Jobs Act of 2017 amended Section 163(j) of the Internal Revenue Code (the "Code"). For federal income tax purposes, Section 163(j) limits the deductibility of interest expense in the current tax year of certain U.S. taxpayers for tax years beginning on or after January 1, 2018. Effective for federal tax year 2025 Public Law 119-21(119 P.L. 21; 2025 Enacted H.R. 1; 119 Enacted H.R. 1; 139 Stat. 72L) modified the calculation of the Section 163(j) limitation. However, Act No. 45 of 2025 was passed on November 12, 2025 which fixed Pennsylvania's conformity to Section 163(j) to the version in effect as of December 31, 2024. As a result, the changes to Section 163(j) made by P.L. 119-21 do not apply for purposes of calculating the applicable Section 163(j) interest expense deduction for Pennsylvania Corporate Net Income Tax ("CNIT") purposes.

This Bulletin provides guidance on how the federal limitations imposed by Section 163(j) are treated for Pennsylvania CNIT purposes.

### Pennsylvania Treatment of Federal Interest Expense

*General Treatment*

Taxpayers will need to calculate their federal interest expense deduction on a separate entity basis. As codified in 72 P.S. § 7401(3)1.(a), taxable income is defined for CNIT purposes as "taxable income … as returned to and ascertained by the Federal Government, or in the case of a corporation participating in the filing of consolidated returns to the Federal Government, the taxable income which would have been returned to and ascertained by the Federal Government if separate returns had been made to the Federal Government for the current and prior taxable years … .[1] However, for tax years beginning after December 31, 2024 taxable income shall be calculated as if section 163(j) of the Internal Revenue Code of 1986 (26 U.S.C. § 163(j)) applied as section 163(j) was in effect on December 31, 2024. As such, taxpayers are compelled to utilize the federal interest expense deduction calculated on a separate

[1] Note that this will extend to foreign entities which claim exemption from the imposition of federal income tax but have sufficient nexus with Pennsylvania to trigger the filing of a CNIT return. In keeping with current practice such an entity will need to prepare a pro-forma federal income tax return and compute its own interest expense limitation under Code Section 163(j) as part of calculating its taxable income.

entity basis using the provisions of section 163(j) as it was in effect in 2024 prior to the passage of P.L. 119-21 for purposes of computing their federal taxable income for use in determining Pennsylvania taxable income. While exceptions will of course exist, specifically for the consolidated return provisions of the applicable federal regulations, it is the general intent that the federal regulations in effect as of December 31, 2024 will be followed to the extent practicable in preparing the taxpayer's pro-forma federal interest expense deduction under Code Section 163(j).

Given that separate company rather than consolidated concepts apply to the federal calculation needed for CNIT purposes, taxpayers will need to include intercompany and third-party interest in their calculation of interest expense under Code Section 163 generally as well as when calculating the limitation imposed by Code Section 163(j) for purposes of their separate company federal taxable income. Each taxpayer with a Pennsylvania CNIT filing obligation will need to perform its own set of calculations on a separate company basis in order to determine if the interest expense limitation applies. This separate company analysis will include determining whether the individual entity has gross receipts sufficient to meet the requirements of Code Section 163(j)(3), when calculated on a separate entity basis without elimination of related party receipts. Additionally, for purposes of implementing Code Section 163(j) Pennsylvania will follow any elections actually made for federal purposes by the taxpayer or its federal consolidated group under subparagraphs (B) or (C) of Code Section 163(j)(7).

*Interest Expense Associated with Addback Provision*

To the extent a taxpayer has interest expense or costs that fall within the definition contained in 72 P.S. § 7401(3)1.(t), as well as a federal limitation under Code Section 163(j), an issue arises as to the proper Pennsylvania CNIT treatment of the respective interest amounts. In such situations the Department expects taxpayers to allocate the federal limitation on a pro-rata basis between the two amounts. Specifically, a fraction consisting of the federal interest expense after application of the limitation over total interest expense without regard to the limitation, multiplied by their Pennsylvania "Interest expense or cost" should provide a taxpayer the amount of current year related party interest potentially subject to addback. Since the federal carryforward provisions make no distinction between related party interest and third-party interest, disallowed related party interest would carry forward and potentially be deductible for federal separate company purposes in future tax periods. As a result, taxpayers should track not only their federal separate company interest deduction carryforward but also the breakout of that amount between third party interest expense and interest expense falling within 72 P.S. section 7401(3)1.(t).

If and when the interest expense which was previously disallowed becomes fully deductible on a federal separate company basis, the taxpayer would follow the analysis for the year of the original expense to determine whether the related party interest should be added back for Pennsylvania purposes. To the extent the previously disallowed interest becomes partially deductible for federal separate company purposes in a future tax year a separate calculation will need to performed in order to

calculate the accurate Pennsylvania addback amount and update the Pennsylvania specific interest addback carryforward. This calculation will again be done on a pro-rata basis and will involve a fraction consisting of the amount of the carryforward interest deducted in the current year over the total amount of the carryforward interest at the start of the tax year, multiplied by the existing Pennsylvania specific interest addback carryforward. The resulting amount will be added back in the current year on the taxpayer's Corporate Tax Report.

See below for examples of these calculations:

| **Example 1 - PA Interest Deduction Addback Partially Added Back in a Future Year** | | | |
|---|---|---|---|
| | **2025** | **2026** | **2027** |
| Limitation on Business Interest Expense | 300,000 | 360,000 | 600,000 |
| | | | |
| Total Current Year Business Interest Expense | 350,000 | 350,000 | 350,000 |
| Interest Limitation Carryforward from Prior Year | - | 50,000 | 40,000 |
| Total Business Interest Expense | 350,000 | 400,000 | 390,000 |
| | - | - | |
| Current Year Interest Deduction with IRC 163(j) limitation | 300,000 | 360,000 | 390,000 |
| | | | |
| Federal Carryforward Amount Deducted in Current Year | - | 10,000 | 40,000 |
| Total Federal Carryover Amount | 50,000 | 40,000 | - |
| | | | |
| PA Interest Addback per 72 P.S. 7401(3)1(t) - current year only | 100,000 | 200,000 | 150,000 |
| Ratio (current year interest after limitation/current year total interest) | 0.86 | 1.00 | 1.00 |
| PA Current Year Interest Addback | 85,714 | 200,000 | 150,000 |
| PA Carryforward Interest Added Back ((federal carryforward amount deducted in current year/total federal carryover amount) * PA Interest Limitation carryforward amount)) | - | 2,857 | 11,429 |
| | | | |
| PA Current Year Interest Addback from Partnerships | - | - | - |
| Total PA Interest Addback | 85,714 | 202,857 | 161,429 |
| PA Interest Limitation Carryforward | 14,286 | 11,429 | - |

| Example 2 - PA Interest Deduction Addback Fully Added Back in a Future Year | | | |
|---|---|---|---|
| | 2025 | 2026 | 2027 |
| Limitation on Business Interest Expense | 300,000 | 240,000 | 600,000 |
| | | | |
| Total Current Year Business Interest Expense | 350,000 | 350,000 | 350,000 |
| Interest Limitation Carryforward from Prior Year | - | 50,000 | 160,000 |
| Total Business Interest Expense | 350,000 | 400,000 | 510,000 |
| | | | |
| Current Year Interest Deduction with IRC 163(j) limitation | 300,000 | 240,000 | 510,000 |
| | | | |
| Federal Carryforward Amount Deducted in Current Year | - | - | 160,000 |
| Total Federal Carryover Amount | 50,000 | 160,000 | - |
| | | | |
| PA Interest Addback per 72 P.S. 7401(3)1(t) - current year only | 100,000 | 200,000 | 150,000 |
| Ratio (current year interest after limitation/current year total interest) | 0.86 | 0.69 | 1.00 |
| PA Current Year Interest Addback | 85,714 | 137,143 | 150,000 |
| PA Carryforward Interest Added Back ((federal carryforward amount deducted in current year/total federal carryover amount) * PA Interest Limitation carryforward amount)) | - | - | 77,143 |
| PA Current Year Interest Addback from Partnerships | - | - | - |
| Total PA Interest Addback | 85,714 | 137,143 | 227,143 |
| PA Interest Limitation Carryforward | 14,286 | 77,143 | - |

*Interest Expense associated with Nonbusiness Income*

Given that business versus nonbusiness income is a state rather than a federal income tax issue, the federal tax authority associated with Code Section 163(j) understandably does not address anything related to nonbusiness income. However, for Pennsylvania CNIT purposes, to the extent interest expense relates to business income in the hands of the taxpayer, the interest expense serves to reduce business income and to the extent it is associated with nonbusiness income the interest expense serves to reduce the taxpayer's nonbusiness income. Consequently, to the extent a Pennsylvania corporate taxpayer has a Code Section 163(j) interest expense limitation and also reports nonbusiness income, it should make a determination of the amount of overall interest expense associated with the nonbusiness income and allocate an interest limitation to that amount on a pro-rata basis. Thereafter to the extent any future year's interest expense limitation is sufficient to allow for the deduction of carryforward amounts, the deduction should be pro-rated between the carryforward interest expense associated with business income and the amount associated with nonbusiness income.

*Limitation on Interest Expense by Code Section 382*

As outlined in Corporation Tax Bulletin 2008-03 to the extent a taxpayer has an existing carryforward of interest expense that was previously limited under Code Section 163(j) and then enters into a transaction which results in the application of Code Section 382, the taxpayer will need to conduct an analysis of the potential

additional limitation on the use of its Code Section 163(j) carryover amounts by Code Section 382. In this situation the taxpayer would check the applicable box on the Form RCT-101 to advise the Department that Section 381/382/Merger NOLs are present and then attach a statement to its corporate tax report detailing the applicable Code Section 382 limitations. See Corporation Tax Bulletin 2008-03 for additional information regarding Code Section 382 limitations in Pennsylvania.

*Treatment of Interest Expense Amounts for Partnerships with Corporate Partners*

For federal purposes, the interest expense limitation is calculated for partnerships at the partnership level itself, but then applied at the partner level.[2] The Department follows that result for CNIT purposes. As a result, once a partnership calculates its own federal interest limitation amount pursuant to Code Section 163(j) as in effect as of December 31, 2024, those interest and excess business interest expense amounts will flow to its corporate partner(s) in the same manner and percentage as other amounts flow up from the partnership to its corporate partner(s). In a tiered structure this would result in a fixed interest limitation amount flowing up through multiple levels until it reaches one or more corporate taxpayers. The corporate partner would then follow the federal rules unique to partners and partnerships for determining when or to what extent the excess business interest expense could be deducted by the corporate partner on a separate entity basis. As mentioned above, the Department expects that partnerships with corporate partners will, as a supplement to the partner's federal K-1, provide distributive share and other relevant information calculated in accordance with Pennsylvania's conformity to the Internal Revenue Code of 1986 and in particular with its conformity to Code Section 163(j). However, to the extent this information is not provided by the partnership to its corporate partner, it is still the corporation's ultimate responsibility to accurately calculate its CNIT liability for Pennsylvania purposes.

It is also important to note that while for purposes of calculating federal adjusted taxable income all interest of a C corporation is treated as "business interest", unless the amounts are designated to a specifically excluded type of business under Reg. § 1.163(j)-10. However, this same treatment does not extend to the interest limitation calculation that must be made by a partnership. As a result, partnerships will need to identify whether interest is properly classifiable as "business interest" as part of calculating the interest limitation passed through to its corporate partner(s). For purposes of this calculation partnerships will need to rely on federal guidance applicable as of December 31, 2024 as the classification of business interest for federal income tax purposes does not correlate with a determination of business vs. nonbusiness income under existing Pennsylvania authority. Ultimately, the corporate taxpayer will still need to make the determination under Pennsylvania authority whether the interest amounts flowing through from the partnership represent business or nonbusiness income for CNIT purposes.

[2] Accordingly, if a partnership determines a Code Section 163(j) limitation the corporate owner is bound by the federal rules for determining the amount of the partnership's interest expense which has flowed through to the corporate partner which can be deducted in the current year.

Finally, to the extent a partnership has interest expense or costs that fall within the definition contained in 72 P.S. § 7401(3)1.(t), as well as a federal limitation under Code Section 163(j), the same issues arise as when a corporation engages in such transactions. Accordingly, the Department expects that when corporate taxpayers receive their share of the interest and excess business interest amounts from each of the partnerships in which they own an interest, the corporate taxpayer will then need to make the necessary calculations in order to determine the amount of the Code Section 163(j) interest limitation to report on its pro-forma federal form 1120.[3] The corporate taxpayer will also need to determine its Pennsylvania interest expense addback from each such partnership and report it on its Pennsylvania Corporate Tax Report for that year. Similar to the methods outlined previously in this bulletin, the corporation will need to track these amounts on a partnership by partnership basis in order to ensure that future Pennsylvania addback amounts are included when the corresponding interest expense is able to be deducted for federal separate company income tax purposes pursuant to Pennsylvania's conformity with the IRC.

**Personal Income Tax Treatment**

In the context of the Pennsylvania Personal income tax ("PIT") the deductibility of interest costs and expenses are determined based whether they constitute ordinary and necessary business expenses, and not by linking them to particular sections of the Code. Accordingly, for PIT purposes the determination of whether and the extent to which interest expenses are deductible should continue without change for periods commencing after December 31, 2024.

For purposes of the calculation of the resident credit, a Pennsylvania resident determines their income in another state according to its rules and calculates their tax liability in that state accordingly. The taxpayer may then take a resident credit based on income taxed by both states, but as always, the credit cannot exceed the Pennsylvania tax liability on the income as determined under Pennsylvania law. Accordingly, to the extent a taxpayer realizes increased income in another state based on the application of the limitations under Code Section 163(j) by that state, the calculation of the taxpayer's resident credit should not be affected as it is limited to the Pennsylvania tax applied to the income as calculated under the applicable Pennsylvania rules.

[3] As noted above, this may include recalculating the appropriate federal interest limitation amount under Code Section 163(j) using IRC § 163(j) as in effect as of December 31, 2024, to the extent that information is not provided to it by a partnership in which it is a partner.