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State and Local Tax

Redefining the Starting Line

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Welcome to the third issue of Redefining the Starting Line, your quarterly guide to navigating the shifting terrain of state income tax compliance after the One Big Beautiful Bill Act (OBBBA). As we continue through 2025 compliance season and embark on the tax provision season for 2026, we will continue our examination of key changes post-OBBBA that can affect the state tax starting line. While our previous issues discussed certain of those changes (IRC Sections174/174A), this issue will focus on IRC Section 163(j) and in particular the effects conformity to that provision have on state taxable income. Finally, we will end with a discussion of IRC Section 59(e) – a provision that had relevance prior to the Tax Cuts and Jobs Act (TCJA), but that was largely dormant with respect to Section 174 in 2022 through 2024 when all R&E expenses were capitalized under the TCJA. Now, post–OBBBA, taxpayers are evaluating this election at the federal level and assessing the potential downstream impacts it may have on the state income tax starting line.

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“DA” importance of Section 163(j) conformity

History

One of the significant OBBBA changes was restoring Section 163(j) to the version that existed prior to 2022. Section 163(j) was enacted to moderate the use of certain tax strategies for US subsidiaries of foreign corporations. The TCJA overhauled Section 163(j) to apply to all taxpayers and was no longer limited in application to US subsidiaries of foreign corporations. Under the TCJA, the provision limited the deduction for business interest expenses to 30% of a taxpayer’s adjusted taxable income (ATI). When TCJA was first enacted, ATI was calculated by adding depreciation and amortization (the “DA”) back to taxable income; however, for tax year 2022 and forward, this limitation changed to include the DA in ATI (i.e., these expenses were no longer added back). As a result, ATI was likely to be lower for tax year 2022 and forward than it had been in the earlier TCJA years. Therefore, the business interest deduction under Section 163(j) was also likely to be lower.

In 2025, the OBBBA reinstated the addback of the DA to ATI, once again increasing the potential ATI against which the limit was applied for federal purposes. In addition, the OBBBA changes created additional complexity around the calculation of the DA. For example, any deductions for tax years 2022-2024 that are accelerated under the OBBBA are generally considered amortization and included in the addback, while any immediate expensing pursuant to Section 174A for tax year 2025 and forward is not considered amortization. This distinction also creates additional computational intricacy with respect to the DA addback to ATI, and ultimately, the Section 163(j) limitation.

State approaches

As with many tax provisions that changed under the OBBBA, there were questions about how states would handle this shift to a more favorable 163(j) limitation that added back the “DA” to ATI for federal purposes. Unsurprisingly, states took a variety of approaches with respect to this change, ranging from adoption of OBBBA changes, decoupling or modifying from the new provision, or maintaining previous positions that kept those states decoupled or modified from the OBBBA change. Below, we discuss the approaches various states have taken to Section 163(j) conformity, specifically for corporations.

Conscious decoupling to pre-TCJA/no limitation

Certain states maintained their historic decoupling to any TCJA generally applicable Section 163(j) limitation. Those states—such as Arkansas, Georgia, and Wisconsin—adopt a version of Section 163(j) as it existed prior to the TCJA. In those states, the Section 163(j) limitation does not apply to domestic

corporations other than as it did in its pre-TCJA form, essentially operating as though the limitation does not exist.

Other states, however, chose to decouple from Section 163(j) entirely. Those states—such as California, Connecticut, Iowa, and South Carolina—do not adopt the generally applicable limit, but also do not adopt any form of Section 163(j). As a result, while these states may have similar federal taxable income (FTI) calculations with respect to those states who adopt a pre-TCJA version of Section 163(j), there may be differences to the extent that a taxpayer has a factual scenario that implicates the pre-TCJA Section 163(j) applicable to US subsidiaries of foreign corporations.

Thus, even in cases where most FTI results would be similar, there still may be differences in a state starting line based on each taxpayer's factual scenario and how the state specifically decouples from Section 163(j).

Decoupling to TCJA

Unlike certain states who have made (and continue to make) the more favorable decision to fully decouple from the generally applicable Section 163(j) limitation, other states have decoupled from OBBBA in order to continue to adopt the less favorable TCJA version of Section 163(j). These states—such as Maryland (for 2025 only), Michigan, and Pennsylvania—specifically decouple from OBBBA Section 163(j) to a TCJA version of Section 163(j), even though their overall IRC conformity may adopt the OBBBA code. As a result, ATI in these states is calculated with the DA (i.e., ATI is calculated after the deductions allowable for the DA).

In still other cases, however, a state may have effectively decoupled from the TCJA, and by extension, Section 163(j), by not updating their annual conformity date. In these states—such as Florida, Hawaii, and Kentucky—the state starting point for tax year 2025, including any effects from Section 163(j), is calculated as though the full TCJA code, rather than the OBBBA code, is in effect.

Modifications

In contrast to decoupling, many states have adopted modifications, either to TCJA or pre-TCJA versions of Section 163(j). These states—such as Indiana, Kansas, and Massachusetts—have achieved state-specific results that approximate either the decoupling to pre-TCJA or TCJA, and calculate a modified ATI that differs from federal ATI. Unlike those states that decoupled, however, these adjustments are simple additions or subtractions that do not affect the state starting point of FTI, simplifying the overall state tax calculation in these states.

Why does it matter?

As noted above, state treatment of Section 163(j) conformity can come in a variety of shapes and sizes – whether through decoupling, modification, or full conformity. Further, the above complexity does not take into account differences between state filing groups and whether the Section 163(j) limitation is calculated on a separate company or group basis.

As a result, a state's ATI calculation may materially vary from the federal baseline and from other states, based on a state's conformity to Section 163(j) and its state-specific group filing and other related rules. As the calculation may vary, the amount of the Section 163(j) deduction for each state also may vary, leading to additional complexities in compliance and tracking of tax attributes, such as Section 163(j) carryovers, which is important not only for compliance purposes but also for tax provision purposes.

In addition, the Section 163(j) limitation also could affect other income-sensitive items, such as the Section 250 deduction. Specifically, the Section 163(j) limit can change a taxpayer's taxable income which, in turn, can impact how much of a Section 250 deduction is allowed. As a result, the state complexity surrounding the Section 163(j) limitation is not limited to the deduction itself, but can ripple through the other parts of the federal tax return that is used for state tax purposes, depending on a state's conformity approach. This complexity increases taxpayers' compliance burdens and complicates tax forecasting and planning, requiring a nuanced understanding of both federal and state income tax rules. Ultimately, these state-by-state differences underscore the need for careful analysis and active management of state conformity during both the tax compliance and tax provision seasons.

A new view on an old provision—conformity to Section 59(e)

In the second issue of Redefining the Starting Line, we discussed the complexities surrounding state tax compliance for Sections 174/174A post-OBBBA. Another wrinkle that implicates both pre-TCJA 174 and 174A and potentially FTI is state conformity to Section 59(e). Prior to the enactment of the TCJA, Section 59(e) allowed a taxpayer to elect 10-year straight-line amortization of research and experimental (R&E) expenditures that were generally subject to expensing or shorter amortization provisions. After the passage of the TCJA, however, Section 59(e) was generally rendered moot for Section 174, as Section 174 controlled the amortization period for both foreign and domestic expenses. OBBBA updated Section 59(e) whereby a taxpayer can elect 10-year straight-line amortization for costs that would otherwise be immediately expensed pursuant to new Section 174A. As a result, taxpayers can now make an election under Section 59(e) for domestic R&E expenditures, which will affect the amount of amortization a taxpayer deducts in a given tax year. This, in turn, can also affect FTI-dependent attributes, such as the Section 163(j) limitation (both due to the FTI limit and as part of the DA in the ATI calculation).

As with other federal tax provisions and elections, state conformity to Section 59(e) can vary. For example, states that fully conform to OBBBA changes via their overall conformity method and specific conformity to Sections 174/174A may follow the federal election. Conversely, states that adopt a TCJA code due to a lagging annual conformity date for tax year 2025 or that adopt TCJA Section 174 via decoupling--such as Florida, Hawaii, and Virginia--might not follow the federal Section 59(e) election. Still other states modify to the TCJA version of Section 174 (e.g., Vermont) and, due to the structure of their statutes and the choice to modify, rather than decouple, these states may conform to the Section 59(e) election.

Perhaps the most complex area of Section 59(e) conformity arises in states that adopt either a pre-TCJA code or a pre-TCJA version of Section 174. Two of these states—California and Wisconsin—allow for a state-specific Section 59(e) election, thereby allowing taxpayers to elect in or out of federal treatment. Other states—such as Alabama and Tennessee—conform to pre-TCJA Section 174, which creates uncertainty about the applicability of the current version of Section 59(e) as, post-OBBBA, it applies to costs that could otherwise be expensed under Section 174A. These states, due to their overall conformity approach, appear to conform to Section 174A under OBBBA, while also still conforming to Section 174 pre-TCJA and therefore could conform to a federal Section 59(e) election.

Navigating state conformity to Section 59(e) alongside Sections 174/174A presents a challenge that can significantly impact amortization, which can lead to a cascade of effects for state tax compliance purposes. Because states take varied approaches, taxpayers face an environment where the same election can produce very different results depending on the state. This patchwork of rules requires careful, state-by-state analysis and proactive planning to address compliance and provision pitfalls. Staying ahead of these complexities is essential to a precise and predictable tax compliance and planning strategy.

What's next?

As we continue to move through the 2025 tax compliance season, it's clear that redefining the starting line for state tax purposes is not a one-time effort but an ongoing journey. The evolving landscape around FTI—shaped by varied state conformity to Sections 163(j), 174/174A, 59(e), and other tax provisions and elections—continues to challenge taxpayers and advisors alike. What we've learned this season is the critical importance of staying informed and nimble with respect to a changing state tax landscape, as these differences could materially impact not only the immediate tax provision but also longer-term planning strategies. Moving forward, embracing a detailed, proactive approach to understanding each state's starting line will be key to managing risk and confidently navigating the complexities introduced by OBBBA and beyond. We look forward to continuing to provide you with the insights and tools needed to meet these challenges head-on through the months and years ahead.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

Robert C Ozmun, *Partner*
+1 612-209-0508
robert.c.ozmun@pwc.com

Peter Kim, *Principal*
+1 213-281-2979
jung.h.kim@pwc.com

Victoria Torchen, *Partner*
+ 1 203-455-4159
victoria.torchen@pwc.com

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