

ALABAMA DEPARTMENT OF REVENUE
INDIVIDUAL AND CORPORATE TAX
ADMINISTRATIVE CODE

CHAPTER 810-3-35
DEDUCTIONS ALLOWED CORPORATIONS GENERALLY

TABLE OF CONTENTS

810-3-35-.01 Deductions Allowed Corporations
810-3-35-.02 Restrictions On The Deductibility Of
Certain Intangible Expenses And Costs
And Interest Expenses And Costs

810-3-35-.01 Deductions Allowed Corporations.

(1) The regulations under §§40-18-15 and 40-18-16, Code of Ala. 1975, apply to corporations with the same force and effect as they apply to individuals with the following exceptions:

(a) Expenses designated as personal expenses are generally personal expenses only to an individual.

(b) Legislative Act 82-667 revised §40-18-15(a)(3) in relation to taxes allowable as deductions for individuals but no comparable change to §40-18-35 was made, therefore, deductions as now allowed individuals for taxes are not applicable to corporations.

1. Taxes, excluding state and local income taxes, imposed from time to time upon the taxpayer by the United States or any of its possessions, territories, or constituent states, or by any county, school district, municipality, or other taxing subdivision thereof may be deducted for the taxable year in which paid or accrued, according to the method of accounting used in computing taxable income.

(i) Possessions and territories of the United States are: American Samoa, Guam, Puerto Rico, and the Virgin Islands. These do not include the Trust Territory of the Pacific Islands: Mariana Islands, Marshall Islands, Palau, Ponape, Truk, and Yap.

(ii) Taxes levied by or paid to a foreign country are not deductible.

(iii) The windfall profits tax imposed by I.R.C. §4986 is deductible.

(iv) Accrual basis taxpayers may deduct taxes only in the year in which the tax accrues, while cash basis taxpayers deduct taxes actually paid during the tax year. A penalty for nonpayment of a tax may not be deducted.

(v) No deduction is allowed for taxes (such as sales and use taxes) imposed on the acquisition of property required to be capitalized pursuant to §40-18-17. Such taxes may be included in the basis of such property as provided in §40-18-6 and recovered through allowable deductions for depreciation and/or depletion as provided in §§40-18-15 and 40-18-16.

2. Net federal income tax may be deducted in the year paid or accrued, according to the method of accounting used in computing taxable income. The federal income tax allowable as a deduction or allocated in paragraph (5) is the net tax liability as accrued and subsequently paid, that is, the amount after subtracting all deductible and/or refundable credits. The federal alternative minimum tax ("AMT") is a prepayment of federal income tax and is not deductible in computing Alabama taxable income. As a consequence, the AMT credit is not considered in relation to Alabama taxable income.

Federal Income Tax		\$55,000.00
Less: Foreign Tax Credit	\$15,000.00	
Investment Credit	7,000.00	22,000.00
Net Apportionable Federal Income Tax		<u>33,000.00</u>

(i) For a cash basis taxpayer federal income tax should be deducted in the year paid.

(ii) An accrual basis taxpayer, should deduct federal income tax:

(I) in the year for which the tax was imposed if the tax is not contested; that is, in the absence of some objective act of protest, affirmative evidence of protest, or affirmative evidence of denial of liability by the taxpayer, or

(II) if the tax is contested it shall be accrued and deducted during the year in which the liability becomes fixed and certain, but in no case later than the date the tax was actually paid.

3. The annual federal income tax deduction for members of an affiliated group filing a consolidated federal income tax return shall be determined according to the method

elected under 26 U.S.C. §1552 (without regard to any election under 26 U.S.C. §1502) for the group's consolidated federal return filed for such taxable year which corresponds to the following methods:

(i) The federal tax liability shall be apportioned among the members of the group according to the ratio which that portion of the consolidated federal taxable income attributable to each member of the group (after taking into account any applicable consolidating eliminations, allowances, limitations and deductions) having taxable income bears to the consolidated federal taxable income.

(I) If the computation of the federal taxable income of a member results in an excess of deductions over gross income, then for the purposes of this computation such member's federal taxable income shall be zero. If the computation of the separate return tax liability of a member in this computation does not result in a positive federal income tax liability, then for the purposes of this computation such member's separate return federal tax liability shall be zero.

(II) This method corresponds to the method described in 26 U.S.C. §1552(a)(1).

(ii) The consolidated federal tax liability shall be apportioned among the several members of the group on the basis of the percentage of the total federal tax, which the tax of such member, if computed on a separate return (after taking into account any applicable consolidating elimination's, allowances, limitations and deductions), would bear to the total amount of federal tax for all members of the group so computed.

(I) If the computation of the separate return tax liability of a member in this computation does not result in a positive number, such member's separate return federal tax liability shall be zero.

(II) This method corresponds to the method described in 26 U.S.C. §1552(a)(2).

(iii) The tax liability of the group (excluding the tax increases arising from the consolidation) shall be apportioned on the basis of the contribution of each member of the group (after taking into account any applicable consolidating eliminations, allowances, limitations and deductions) to the consolidated federal taxable income of the group; provided such amount does not exceed the liability of such member on a separate return basis, in which case the member's deduction is limited to the amount it would have paid on a separate return basis. Any tax

increases arising from the consolidation shall be distributed to the several members in direct proportion to the reduction in federal tax liability resulting to such members from the filing off the consolidated return as measured by the difference between their federal tax liabilities determined on a separate return basis and their federal tax liabilities based on their contribution to the consolidated federal taxable income.

(I) If the consumption of the federal taxable income of a member results in an excess of deductions over gross income, then for the purposes of this computation such member's federal taxable income shall be zero. If the computation of the separate return tax liability of a member in this computation does not result in a positive federal income tax liability, then for the purposes of this computation such member's separate return federal tax liability shall be zero.

(II) This method corresponds to the method described in 26 U.S.C. §1552(a)(3).

(iv)(I) When no election has been made for any taxable year in which a consolidated federal return is filed, the method described in (i) above shall apply.

(II) Any method other than those described in (i), (ii), or (iii) above must be requested from and approved by the Department. If approval has not been granted by the Department for the use of any method other than those described in (i), (ii) or (iii) above, the method described in (i) shall be used.

(v) If either the numerator, denominator, or both, in the ratios described in (i), (ii), (iii), or (iv) above are zero or less than zero, then no federal income tax will be apportioned to the members involved from the consolidated federal return.

(vi) If a corporation is a member of more than one affiliated group filing a consolidated federal return during a tax year, such corporation shall compute its share of the consolidated federal tax of each group using a method described in (i), (ii), (iii) or (iv) above which was in effect for each such group during the time the corporation was a member of such group.

4. If an accrual basis taxpayer has a federal carryback that produces a refund, the tax refunded accrues to the year from which the item is carried.

(i) EXAMPLE: A taxpayer has more investment tax credit available in 1979 than can be utilized in 1979 and carries this excess back to 1976 and 1977. The 1976 and 1977 federal

income taxes will be reduced and refunded, but the refund is negative federal income tax in 1979. These refunds are accomplished by filing a federal Form 1139 or amended federal returns.

(ii) If the taxpayer is a member of a group filing a consolidated federal return, the refund will be apportioned to each corporation in the same ratio that the tax deduction being refunded was originally apportioned.

(iii) If the taxpayer is a foreign corporation the refund will be apportioned to Alabama income at the same rate the tax deduction was originally apportioned to Alabama income.

(iv) The net refund attributed to Alabama will be used to reduce the current federal income tax deduction, if any. If the refund results in a negative deduction (the refund is larger than the current deduction), the result will increase taxable income.

(c) The provisions of §§40-18-15(a)(13), (15), (16), and 40-18-15(b) and regulations thereunder do not apply to corporations. Medical expenses, to be deductible by a corporation, must be business expenses. No standard deduction is available to corporations.

(d) Under §40-18-35(2), a corporation is not permitted to deduct interest paid on an indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), if the interest income from the obligations or securities is exempt from Alabama income tax.

(e) Section 40-18-15(a)(6) which allows a deduction for casualty, and theft losses, has no counterpart for corporations. However, such losses to a corporation normally would be business losses.

(f) Mutual insurance companies (other than mutual life or mutual marine insurance companies) and marine insurance companies are entitled to special deductions as provided in §§40-18-35(8) and 40-18-35(9).

(g)1. Charitable contributions: For taxable years beginning before January 1, 1985, the limitation on contributions, in the case of a corporation, is five percent of the corporation's net income computed without the benefit of the deduction for contributions. Reg. 810-3-15-.17 should be modified to this extent when it is applied to a corporation.

Actual payment of the contribution must be made to a recognized charitable institution to be deductible.

2. For taxable years beginning after December 31, 1984, and before January 1, 1990: charitable contributions by corporations are allowed in the same manner and subject to the same limitations as provided by 26 U.S.C. §170 as in effect on January 1, 1985.

3. For taxable years beginning after December 31, 1989, charitable contributions are allowed in the same manner and subject to the same limitations as provided by 26 U.S.C. §170 as in effect from time to time.

(i) For the purpose of this section the limitation is 10% of total income computed under Alabama law, after taking into account all other allowable deductions (except the net operating loss carryforward), but without the benefit of this deduction.

(ii) For accrual basis taxpayers, actual payment of the contribution must be made not later than the 15th day of the third month following the close of the tax year.

(iii) If the total contributions available for deduction in the year exceed the 10% limitation in subsection (i) above, the excess may be carried over to the next five succeeding years in chronological order. The amount to be carried over in succeeding years is the excess, if any, of the limitation for the succeeding year over the current contributions for that year.

(iv) The amount of any deduction allowable under this section for a contribution of property must be determined by the amount the fair market value of the property exceeds the taxpayer's basis in the property. In the case of a charitable contribution of less than the taxpayer's entire interest in the property contributed, the taxpayer's adjusted basis in such property shall be apportioned between the interest contributed and any interest not contributed.

(h) For tax years beginning after December 31, 1989, the deduction for expenses of travel, entertainment and meals incurred by corporations shall be determined according to and subject to the same limitations as provided in 26 U.S.C. §274. See Regulation 810-3-15.02.

(i) For tax years beginning after December 31, 1989, if a personal service corporation has in effect an election under 26 U.S.C. §444 (relating to the use of a taxable year other than the required taxable year) and does not satisfy the minimum distribution requirements as defined in 26 U.S.C. §280H, the

minimum deduction otherwise allowable under this chapter for applicable amounts paid or incurred by such corporation to employee-owners shall not exceed the minimum deductible amount as defined in 26 U.S.C. §280H.

1. If any amount is not allowed as a deduction for a taxable year under part (i) above, such amount shall be treated as paid or incurred in the succeeding taxable year.

2. For the purposes of this part, the terms "minimum distribution requirements," "maximum deductible amount," "employee-owner," and "applicable amount" shall have the same meaning as defined in 26 U.S.C. §280H.

(2) Dividends (including liquidating dividends) are deductible if received from a corporation or any subsidiary corporation taxable under this title whether received in cash or property or both, if at the time of the receipt of such dividends the receiving corporation owns stock of the distributing corporation:

(a) possessing at least 50% of the total combined voting power of all classes of stock entitled to vote and

(b) constituting at least 50% of the total number of shares of all classes of stock other than classes of stock which are limited and preferred as to dividends.

NOTE: Ownership of stock under this paragraph must be direct ownership. Alabama law has no provision regarding indirect ownership (attribution rules).

(3) Losses from bad debts

(a) For tax years beginning before January 1, 1985, a deduction is allowed for all debts which became worthless during the taxable year if sustained in the conduct of the taxpayer's regular trade or business. Only actual write-offs may be deducted. The reserve method may not be used for these years.

(b) For all taxable years beginning after December 31, 1984, and beginning before January 1, 1990, either actual write-offs of bad debts or a reasonable addition to a reserve for bad debts may be used. Bad debts are deductible to the extent allowed by 26 U.S.C. §166 as in effect on January 1, 1985.

1. If a taxpayer changes from actual write-offs to a reserve method, or from a reserve method to actual write-offs, proper adjustments must be made so that no deduction is taken

more than once for the same bad debt and so that no allowable deduction will not be deducted due to the change in method for deducting bad debts.

2. Any reserve method and the computation thereof allowed by the U.S. Secretary of the Treasury pursuant to 26 U.S.C. §166(c) and U.S. Treasury Regulation §1.166-4, as in effect January 1, 1985, will be allowed by this regulation.

3. The Alabama law has no provision for the establishment of an initial reserve, only for a reasonable addition to a reserve. Therefore, the provisions of 26 U.S.C. §481 and U.S. Treasury Regulation §§1.481-1, et seq. are not applicable in computing the allowable addition to the bad debt reserve under Alabama law.

(c) For all taxable years beginning after December 31, 1989, a deduction is allowed in accordance with 26 U.S.C. 166 for all debts which become worthless during the taxable year, if sustained in the conduct of the taxpayer's regular trade or business.

(4) A deduction is allowed for all amounts invested during the taxable year in devices, parts of devices, systems or facilities used or placed in operation in the state of Alabama, or to be used or placed in operation in the State of Alabama primarily for the protection of the public and the public interest through the control, reduction, or elimination of air or water pollution; provided, however, that in lieu of deducting such amounts, the corporation may elect to amortize all such amounts over such period (not exceeding the useful life of devices, parts, systems or facilities for which such amounts were expended) as it specifies in its tax return for the taxable year during which such amounts were expended, in which case it shall be entitled to appropriate deductions for the taxable years so specified; and provided further:

(a) that the taking of any deductions authorized by subsection (12) shall be optional with the corporation; and

(b) that if any such deduction is taken with respect to any such devices, parts of devices, systems or facilities, such corporation shall not be permitted any allowance for depreciation or obsolescence thereof otherwise allowable under this §40-18-35.

(c) The election to expense qualified pollution control capital expenditures must be made in the return for the taxable year in which the expenditures are incurred and the

election may not be made, revoked or modified after the return is filed.

(d) Definitions:

1. "Water Pollution" means the discharge or deposit of sewage, industrial wastes, or other wastes in such condition, manner or quantity as may cause ground or surface water to be contaminated, unclean, or impure to such an extent as to make said waters detrimental to the public health or to the health of animals, wildlife, fish, marine life or aquatic life; unsuitable with reasonable treatment for use as present or possible future sources of public water supply; or unsuitable for recreational, commercial, industrial, agricultural, or other reasonable uses.

2. "Air Pollution" means the presence in the outdoor atmosphere of one or more air contaminants or combinations thereof in such quantities and of such characteristics, location and duration which are injurious to human, plant or animal life or to property, or which unreasonably interfere with the comfortable enjoyment of life or property or to the conduct of business within such areas of the state as shall be affected thereby.

3. "Air Contaminant" means dust, fumes, mist, smoke, other particulate matter, vapor, gas, odorous substances, or any combination thereof.

4. "Air Cleaning Device" means any method, process, or equipment which removes, reduces, or renders less noxious air contaminants discharged into the atmosphere.

(e) The Department will recognize as subject to deduction or amortization any devices, parts of devices, systems or facilities used or placed in operation in the state of Alabama and approved for the control, reduction, or elimination of air or water pollution by the Water Improvement Commission, the Air Pollution Control Commission or by the Alabama Department of Environmental Management.

(f) The deduction allowed by this section is for expenditures in the nature of capital items and does not include expenses for maintenance, operation or supplies.

(5) Corporate employers' deduction for contribution to an employees' trust or annuity plan or compensation under a deferred-payment plan and bond purchase plan are allowed as follows:

(a) For tax years beginning before January 1, 1984, corporations may deduct their contributions to stock bonus, pension, profit sharing, annuity, deferred compensation, and bond purchase plans as they qualify and are allowed by I.R.C. §§404 and 405, as in effect from time to time.

(b) For tax years beginning after December 31, 1983, and before January 1, 1990, corporations may not deduct their contributions to bond purchase plans since I.R.C. §405 was repealed for all years after January 1, 1984.

(c) For tax years beginning after December 31, 1989, corporations are allowed to continue to deduct their contributions to a qualified employees' stock bonus, pension, profit-sharing or annuity plan, or deferred compensation plan within the same limitations as allowed by I.R.C. §404.

(6) For qualified expenditures made on or after May 17, 1985, a corporation which incurs expenses during the taxable year for the removal of architectural or transportation barriers to the handicapped may elect to deduct such expenditures, even if the expenditures are capital in nature. The maximum amount of the deduction is \$35,000. If the election is made to deduct such expenses, no depreciation may be taken in connection with such expenditures. The election may not be made, changed or revoked after the return is filed.

(7) (a) For taxable years beginning after December 31, 1984, a corporation may amortize organizational expenditures over any period of not less than sixty (60) months. To qualify for amortization, the expenditures must have been:

1. incidental to the creation of the corporation,
2. chargeable to its capital account, and
3. of a character, which if expended incident to the creation of a corporation with a limited life, would be amortizable over such life.

(b) The taxpayer shall elect the amortization period in the return for the first taxable year in which the corporation engages in business. The election may not be made, changed, or modified after the due date (with extensions) for filing the return for such first taxable year.

(8) See Reg. 810-3-35-.02 for apportionment and allocation of allowable deductions of foreign corporations.

(9) The Internal Revenue Code contains provisions similar to those in this section. Decisions and interpretations of the federal courts and agencies will be given due weight in interpreting this section.

Authors: Cindy D. Norwood, Verlon R. Frost

Statutory Authority: Code of Ala. 1975, §40-18-35.

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810-3-35-.02 Restrictions On The Deductibility Of Certain Intangible Expenses And Costs And Interest Expenses And Costs.

(1) In accordance with the terms of §40-18-35(b)(1), Code of Ala. 1975, (hereafter "Ala. Code") for purposes of computing its taxable income, a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members.

(2) The corporation shall make the adjustments required in paragraph (1), unless:

(a) The corporation establishes, to the Department's satisfaction, in a writing attached to the corporation's Alabama corporate income tax return, that the adjustments are unreasonable, (See (3)(h) below)

(b) The corporation and the Commissioner of Revenue agree in writing to the application or use of alternative adjustments and computations, (See (3)(i) below)

(c) The corporation establishes, to the Department's satisfaction, in a writing attached to the corporation's Alabama corporate income tax return, that the transaction giving rise to the interest expenses and costs or the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any Alabama tax and the related member is not primarily engaged in the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property, or in the financing of related entities, (See (3)(b) and (c) below) or

(d) The corporation establishes, to the Department's satisfaction, in a writing attached to the corporation's Alabama

corporate income tax return, that the item of income corresponding to the taxpayer's expense was in the same taxable year subject to a tax based on or measured by the related member's net income in Alabama or any other state of the United States, or a foreign nation which has in force an income tax treaty with the United States, if the recipient was a "resident" (as defined in the income tax treaty) of the foreign nation. (See (3) (e), (f) and (g) below).

(e) The attachment(s) required by (2) (a), (c) and (d) above shall be in a format to be prescribed by the Department of Revenue.

(3) Definitions and Operating Rules

(a) **"Specified Intangible Activities"** means, for purposes of this regulation, the intangible related activities referred to in Ala. Code §40-18-35(b) (3) specifically including the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property.

(b) **"Primarily Engaged"** means that as a percentage of total receipts, receipts from the specified intangible activities or the receipts from financing related entities exceeds the receipts from any other readily identifiable category of receipts.

1. EXAMPLE. Related member has \$1,000 of total receipts: \$400 of royalty receipts from the licensing of intangibles, \$300 of receipts from the sale of widgets and \$300 of receipts from widget repair services. Because related member's receipts from a specified intangible activity exceed its receipts from any other readily identifiable category of receipts, related member is "primarily engaged" in that activity for purposes of Ala. Code §40-18-35(b) (3) and paragraph (2) (c) of this regulation.

2. EXAMPLE. Related member conducts manufacturing operations, licenses intangible property and loans money to Taxpayer. Related member has \$1,000 of receipts: \$225 of royalty receipts from Taxpayer, \$225 of interest receipts from Taxpayer, \$400 of receipts from the sale of goods to Taxpayer, and \$150 of miscellaneous receipts. Due to the fact that a greater percentage of related member's total receipts (40%) is from the sale of goods, related member is not "primarily engaged" in either the specified intangible activities or the financing of related entities.

3. With respect to the indirect expenses described in (3)(d) below, the primarily engaged definition described in (3)(b) above should be applied to both the related member that transacts business directly with the taxpayer and to the related member that transacts business indirectly with the taxpayer through one or more additional related members. If either related member is primarily engaged in the specified intangible activities or the financing of related entities, the taxpayer may not avail itself of the exception described in (2)(c) above.

(c) **"Related Member"** includes but is not limited to any corporation that is included in the taxpayer's federal consolidated corporate income tax return or any disregarded entity or subchapter K entity a majority of whose income is included in the taxpayer's federal income tax return (separate or consolidated).

1. For purposes of determining whether a related member is primarily engaged in the specified intangible activities or the financing of related entities, subchapter K entities or entities that are disregarded for federal income tax purposes shall be separately considered.

2. EXAMPLE. Corporation A is the single member owner of Limited Liability Company B ("LLC B"), an entity disregarded for federal income tax purposes. Corporation A owns intangible property that it licenses to Corporation C, an Alabama corporate taxpayer. LLC B owns and operates retail store locations. Corporation A and Corporation C are wholly owned subsidiaries of Company D. For purposes of Corporation C, both Corporation A and LLC B are related members. Because LLC B, is a related member, separate and apart from Corporation A, LLC B's activities will not be considered for purposes of determining whether Corporation A is primarily engaged in the specified intangible activities.

(d) Any expense incurred by a taxpayer corporation, if the expense is related to an intermediate intangible or interest expense paid from one related member to a second related member, is an indirect intangible or interest expense that satisfies the definition of intangible expense and cost provided in Ala. Code §40-18-1(9) or interest expense and cost provided in Ala. Code §40-18-1(11).

1. EXAMPLE. Corporations B and C are related members with respect to Corporation A. Corporation A is an Alabama taxpayer that sells products it purchases from Corporation B on a cost plus basis. Corporation B licenses intangible property from Corporation C and makes intangible expense payments to Corporation C based in part on the sales Corporation B makes to Corporation A. To the extent the intangible expenses Corporation

B pays to Corporation C are reflected in the costs of the products Corporation A purchases from Corporation B, the direct intangible expenses of Corporation B are considered to be indirect intangible expenses of Corporation A. Furthermore, for purposes of Ala. Code §40-18-35(b)(3) and subsection (2)(c) of this regulation Corporation A is deemed to directly pay an intangible expense to Corporation B and indirectly pay an intangible expense to Corporation C.

(e) **"Subject to a tax based on or measured by the related member's net income"** means that the receipt of the payment by the recipient related member is reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor.

(f) **"[R]eported and included in income for purposes of a tax on net income"** means reported and included in post-allocation and apportionment income for purposes of a tax applied to the net income apportioned or allocated to the taxing jurisdiction.

(g) The exception described in (2)(d) is allowed only to the extent the recipient related member includes the corresponding item of income in post-allocation and apportionment income reported to the taxing jurisdiction.

1. **EXAMPLE.** Corporation A makes a \$100 intangible expense payment to Corporation B, a related member with respect to Corporation A. Corporation B files an income tax return in State B where it apportions and or allocates 5% of its income, but files no other income tax returns. Corporation A must add-back \$95 of the otherwise deductible \$100 intangible expense payment it makes to Corporation B.

(h) The adjustment required in (1) above will be considered unreasonable if:

1. The taxpayer establishes that, based on the entirety of the taxpayer's particular facts and circumstances, the adjustments have increased the taxpayer's Alabama income tax liability to an amount that bears no fair relation to the taxpayer's Alabama presence, or

2. The taxpayer establishes that the interest or intangible expense was paid to a related member that "passed through" the interest or intangible payment via a corresponding interest or intangible expense payment to an unrelated third party. This subdivision of the unreasonable exception is subject to the limitations

described in paragraphs (i), (ii), and (iii) below. Taxpayers must first apply the limitation imposed in paragraph (i) to determine the amount of "pass through" interest or intangible expense. "Pass through" interest or intangible expense will be subject to the additional limitations contained in paragraphs (ii) and (iii). When the taxpayer's related member interest expense exceeds both limitations, the limitations should be applied together as described in Example 2.

(i) Related member interest or intangible expense paid to a related member that receives more related member interest or intangible income (expense to the payor) than it pays interest or intangible expense to unrelated third parties will be limited because only a portion of the related member interest or intangible expense/income is considered to have "passed through" to the unrelated third parties.

(I) EXAMPLE 1. Taxpayer A makes a \$100 interest payment to Related Member B. Related Member B receives a total of \$400 of related member interest income (\$100 from Taxpayer A plus \$300 from other related payors). Related Member B pays \$200 of interest expense to unrelated third parties. Related Member B will be deemed to have passed through to unrelated third parties only 50% of the interest expense/income it received from Taxpayer A. Only \$50 of Taxpayer A's \$100 related member interest expense payment to Related Member B will be deemed to have been passed through to unrelated third parties and qualify for the unreasonable exception.

(ii) With respect to both interest and intangible expenses, if the interest or royalty rate charged the taxpayer by the related member exceeds the interest or royalty rate charged the related member by unrelated third party lenders or licensors, then the excess expense will not qualify for the unreasonable exception and must be added back. If multiple lending or licensing arrangements exist between the taxpayer and the related member, or the related member and the unrelated third-party lender or licensor, then a weighted average rate should be calculated by dividing total interest expense by total interest bearing debt. The weighted average rate should then be used to determine the existence of non-qualifying excess interest or intangible expense. See (I) Example 2.

(iii) With respect to interest expense, if the taxpayer's debt over asset percentage exceeds the consolidated unrelated third party debt over asset percentage of its federal affiliated group (as represented by interest bearing debt reported on the Schedule L balance sheet(s) included in the consolidated and pro forma federal income tax returns), then the interest expense associated with the excess debt must be added

back on Schedule A of the Alabama Form 20C and cannot qualify for the unreasonable exception based on a conduit financing arrangement.

(I) EXAMPLE 2. Taxpayer B makes interest expense payments of \$100 during its taxable year to its parent Company A (a related member) to service a \$1,000 debt between B and A. Company A's related member interest rate is 10% calculated by dividing its related member interest expense (\$100) by its related member debt (\$1000). Company A makes interest expense payments of \$200 to Unrelated Lenders C and D to service the \$4,000 of total debt existing between A and Unrelated Lenders C and D. A's weighted average unrelated third party interest rate is five percent (5%) calculated by dividing total unrelated third party interest expense (\$200) by total unrelated third party interest bearing debt (\$4,000).

(II) Taxpayer B's separate company federal income tax return Schedule L balance sheet shows \$1,500 of assets and \$1,000 of interest bearing debt which produces a debt over asset percentage of 66.7%. The Company A and Subsidiaries' federal consolidated income tax return Schedule L balance sheet shows \$6,000 of assets and \$3,000 of unrelated third party interest bearing debt which produces a debt over asset percentage of fifty percent (50%). Because Taxpayer B's debt over asset percentage, 66.7%, exceeds the group's unrelated third party debt over asset percentage, 50%, the amount of Taxpayer B's related member interest expense that may qualify for the unreasonable exception is limited. The limitation is calculated by multiplying B's assets (\$1,500) by the lower of the taxpayer's debt over asset percentage or the group's unrelated third party debt over asset percentage (50%) and then multiplying the product (\$750) by the lower of the taxpayer's related member interest rate or the related member's unrelated third party interest rate (5%), which yields an ultimate limitation of \$37.50.

(i) Requests for alternative adjustment agreements provided for in Code of Ala. 1975, §40-18-35(b)(2) and subdivision (2)(b) of this regulation should be directed to the Alabama Revenue Commissioner and submitted in writing to the Department of Revenue at least ten (10) weeks prior to the filing of the taxpayer's corporate income tax return for which the agreement is requested. The request should describe both the taxpayer's particular facts and circumstances that warrant an alternative adjustment and the terms of the proposed alternative adjustment. If the taxpayer is unable to submit the request ten (10) weeks prior to the filing of the return, the taxpayer should pay the tax in full and request a refund in the request for an alternate adjustment agreement.

Author: Joe Garrett

Statutory Authority: Code of Ala. 1975, §§40-2A-7(a)(5), 40-18-35(b).

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