ALABAMA DEPARTMENT OF REVENUE INDIVIDUAL AND CORPORATE TAX ADMINISTRATIVE CODE

CHAPTER 810-3-35
DEDUCTIONS ALLOWED CORPORATIONS GENERALLY

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810-3-35-.01 Federal Income Tax Deduction.

(1) Corporations may deduct federal income taxes (FIT) paid or accrued during the taxable year and attributable to their Alabama income. The amount and method of deduction to be allowed for state income tax purposes is determined by Alabama Department of Revenue rules. See Standard Oil Co. v. State, 55 Ala. App. 103, 313 So. 2d 532, cert. denied, 313 So. 2d 540 (1975).

(a) The FIT attributable to Alabama may be deducted in the year paid or accrued and subsequently paid, according to the method of accounting used in computing taxable income.

1. For a cash basis taxpayer federal income tax should be deducted in the year paid. See Paragraph (4).

2. 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 subsequently paid 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.

(b) For purposes of this rule, FIT is the amount of federal income taxes paid or accrued and subsequently paid by the taxpayer for a tax period. This amount includes adjustments for refundable and nonrefundable credits, special deductions, net operating loss deduction, alternative minimum tax (and

minimum tax credit) and similar adjustments. For taxpayers that file as part of a federal consolidated group, alternative minimum tax (AMT) and the minimum tax credit (MTC) are allocated using the method described in subparagraph (3)(e) and subparagraph (3)(f).

(2) For an accrual basis taxpayer that does not file as a member of a federal consolidated income tax return and who apportions and/or allocates income within and outside of Alabama: The amount of FIT attributable to Alabama is determined by multiplying the FIT times a fraction, of which the numerator is the taxpayer's income apportioned and/or allocated to Alabama, and the denominator is the taxpayer's total income earned both within and outside Alabama, computed under applicable Alabama law. To the extent a net loss is allocated and/or apportioned to Alabama (the numerator of the fraction is negative), no FIT will be attributed to Alabama.

Example: Company A is an Alabama taxpayer who apportions a percentage of its income within and outside of Alabama. Company A had Federal Taxable income of $200,000 and $40,000 in FIT for the tax year. Company A's income apportioned to Alabama is $50,000. Company 'A' is apportioned 25% or $10,000 of the net federal income tax liability. ($50,000/$200,000 = 25% * $40,000 = $10,000).

(3) For an accrual basis taxpayer that files as a member of a federal consolidated income tax return: The taxpayer shall apportion the consolidated FIT liability only among the members of the group that individually report positive federal taxable income. Each member is apportioned a share of the consolidated FIT based on a fraction, the numerator of which is the member's positive federal taxable income and the denominator of which is the sum total federal taxable income of all members separately reporting positive federal taxable income.

(a) Example: Company A, Company B, and Company C file as part of a consolidated income tax return for federal income tax purposes. Company A is the only member of the affiliated group that files an income tax return in Alabama. The companies have Federal Taxable Incomes of $150,000, $50,000, and $100,000 (totaling $300,000), respectively. The affiliated group accrued and subsequently paid $60,000 in net federal income tax during this tax year. Company A is apportioned 50% or $30,000 of the federal income tax liability of the group. ($150,000/$300,000 = 50% * 60,000 = $30,000).

(b) Example: Company A, Company B, and Company C file as part of a consolidated income tax return for federal income tax purposes. Company A is the only member of the affiliated group that files an income tax return in Alabama. The companies have Federal Taxable Incomes of $150,000, -$25,000, and $350,000 (positive entities totaling $500,000), respectively. The

affiliated group accrued and subsequently paid $150,000 in federal income tax during this tax year. Company A is apportioned 30% or $45,000 of the federal income tax liability of the group. ($150,000/$500,000 = 30% * $150,000 = $45,000).

(c) To the extent the consolidated FIT liability for tax period is zero or the federal consolidated group earned a net operating loss for the tax period, the Alabama taxpayer will be apportioned no FIT liability even if the AL taxpayer separately computed positive federal taxable income for the tax period.

Example: Company A, Company B, and Company C file as part of a consolidated income tax return for federal income tax purposes. Company A is the only member of the consolidated group that files an income tax return in Alabama. The companies have Federal Taxable Incomes of $150,000, -$25,000, and -$350,000, respectively. The consolidated group earned a -$225,000 net loss and paid $0 in FIT for this tax year. Even though Company A earned positive taxable income, no FIT was due on a consolidated basis to be apportioned to Company A and Company A will receive no FIT deduction for the tax period.

(d) If the taxpayer allocates and/or apportions its income both within and outside of Alabama, the taxpayer shall compute the portion of FIT attributable to Alabama consistent with Paragraph (2).

(e) Alternative Minimum Tax: For a taxpayer that files as a member of a federal consolidated group, the consolidated alternative minimum tax (AMT) liability shall be apportioned only among the members of the group that individually report positive alternative minimum taxable income (AMTI). The apportioned amount is determined by multiplying AMT, as accrued and subsequently paid by the federal consolidated group, times a fraction. The numerator of which is the taxpayer’s positive AMTI and the denominator is the aggregate amount of positive AMTI of the component members of such group.

Example: Company A, Company B, and Company C filed a consolidated income tax return for federal income tax purposes. The following federal consolidated group paid no regular income tax during the tax year but paid $75,000 in AMT. Company A, Company B, and Company C computed AMTI of $150,000, $125,000 and $100,000 (totaling $375,000), respectively. Company A is apportioned 40% or $30,000 of the AMT liability of the group (150,000/375,000 = 40% * $75,000 = $30,000).

(f) If a federal consolidated group is allowed to reduce its FIT liability by applying a Minimum Tax Credit (MTC), then the MTC must be attributed to the members of the group consistent

with AMT previously allocated pursuant to subparagraph (e) above. In no case shall the cumulative MTC attributed to a taxpayer exceed the cumulative AMT attributed to a taxpayer.

(4) For Cash basis taxpayers: To the extent the taxpayer does business within and without Alabama, follow the general provisions provided in Paragraph (2) to determine the portion of the taxpayer's FIT that is attributed to Alabama. If the taxpayer files as part of a federal consolidated income tax return, follow the general provisions in Paragraph (3) to calculate the portion of consolidated FIT attributed to the taxpayer. The amount of consolidated FIT allocated to the taxpayer pursuant to Paragraph (3) and/or the amount attributed to Alabama pursuant to Paragraph (2) is based on the actual amount of federal income taxes paid during the tax period. The taxpayer is entitled to a federal income tax deduction, even if the taxpayer earned a net operating loss for the tax period, if actual federal income tax payments were made during the tax period.
Author: Holly H. Coon
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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
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