

**Establishment of Qualification for §40-18-35(b), §40-18-24(b) Exceptions.**

If the taxpayer incurred related member intangible and/or interest expenses that were not added back to apportionable income on its Alabama Income Tax Return, it must establish there is a qualified exception. The possible exceptions are listed below:

**Section 5** – The recipient related member’s corresponding item of income was post-allocation and apportionment subject to a tax on net income in Alabama or another state or a foreign nation (of which, the recipient related member is a resident) which has in force an income tax treaty with the United States. §40-18-35(b)(1), §40-18-24(b).

**Section 6** – The taxpayer establishes that the add-back of interest and/or intangible expenses is unreasonable or the Commissioner of Revenue and the taxpayer have agreed, in writing, to an Alternative Adjustment Agreement. §40-18-35(b)(2), §40-18-24(d), §40-18-35(b)(4).

**Section 7** – The recipient related member is a) not primarily engaged in the acquisition, use, licensing, etc. of intangible property or the financing of related entities and b) the underlying transaction(s) giving rise to the related member intangible/interest expenses did not have as a principal business purpose the avoidance of Alabama tax. §40-18-35(b)(3), §40-18-24(e).

**General Instructions**

1. **Schedule PAB must be completed for all recipient related members receiving interest and/or intangible payments. Columns are provided on Schedule PAB to report each recipient separately. For more detailed help on how to complete this form, see the example following these instructions.**
2. **If a partnership or S corporation makes interest/intangible payments to a related member, Form PAB should be completed and attached to the entity’s return.**
3. **To determine Lines 2 and 3, multiply the total interest/intangible payment by the ownership percentage of the entity.**

**Section 5 – Exemption related to §40-18-35(b)(1), §40-18-24(b)**

To verify that the related member intangible/interest expense qualifies for the exception in §40-18-35(b)(1), §40-18-24(b), please provide the following:

- A. The jurisdiction(s) where the recipient related member is “subject to tax.” The **recipient related member interest/intangible income must be “subject to tax” on a post-allocation and apportionment basis** in these jurisdictions. A document listing the applicable jurisdictions may be attached if the space provided is not sufficient. **Do not include consolidated/combined return jurisdictions where intercompany expenses are eliminated or are offset.**
- B. The amount of expense the taxpayer paid to the recipient related member, but is not required to add back pursuant to §40-18-35(b)(1), §40-18-24(b).
- C. If the recipient related member files in a jurisdiction where intangible and/or interest income is allocated rather than apportioned, enter the amount of intangible and/or interest income allocated to this jurisdiction.
- D. Subtract the intangible/interest income allocated by the recipient related member on Line 5c from the total amount of interest and/or intangible expense paid by the taxpayer on Line 5b.
- E. Enter the sum of all recipient related member apportionment factors for the jurisdictions listed on Line 5a.
- F. Multiply the sum of all apportionment factors on Line 5e by the adjusted intangible/interest amount on Line 5d.
- G. Add the amount allocated to jurisdiction(s) on Line 5c and the amount apportioned to jurisdiction(s) on Line 5f.

**Section 6 – Application for Exception Pursuant to Section 40-18-35(b)(2) and Section 40-18-35(b)(4), Section 40-18-24(d) and Section 40-18-24(f)**

• **Section 40-18-35(b)(2), Section 40-18-24(d)** – Application for the exception provided in Section 40-18-35(b)(2) and Section 40-18-24(d) must be made in the following prescribed manner. Applicants must provide: (1) Detailed financial data and corresponding work papers produced in the analysis of the circumstances particular to the taxpayer that make the adjustment unreasonable pursuant to Rule 810-3-35-.02(3)(h) and/or (2) A signed Alternative Adjustment Agreement between the taxpayer and the Commissioner of Revenue. Please note that the presence of a non-tax business purpose, arm’s length pricing, and economic substance of these transactions alone do not qualify for an exception. See Section 40-18-35(b)(3).

• **Section 40-18-35(b)(4), Section 40-18-24(f)** – Application for the exception provided in Section 40-18-35(b)(4) and Section 40-18-24(f) must be made in the following prescribed manner. Applicants must provide a detailed calculation of the interest being transferred through the “recipient related member” to an unrelated third party. If the recipient related member receives interest payments from multiple sources and does not pass-through the entire interest payment, the amount passed through is determined on a pro rata basis.

**Section 7 – Exemption related to §40-18-35(b)(3) and 40-18-24(e)**

To establish that the related member intangible/interest expenses qualify for the exception in §40-18-35(b)(3) and §40-18-24(e), provide the following:

7. The amount of expense the taxpayer paid to the recipient related member, but is not required to add back pursuant to §40-18-35(b)(3) and §40-18-24(e).

**NOTE: If the related member is a partnership or disregarded entity for federal income tax purposes, the receipts included on lines 9a through 9e should only include the receipts for the related member receiving the interest or intangible income, not the owner or the other disregarded entities that the related member may be owned by or exist in the same group or division within the same group.**

**Sections – 8 and 9** The recipient related member’s receipts by category.

**Example:**

- Intangible Receipts – (Royalties, Factoring Expenses, etc.)
- Interest Receipts
- Gross receipts from the sale of tangible property
- Rental Income

10. If interest or intangible receipts are greater than any other category of receipts, the recipient related member is deemed to be primarily engaged in the specified activities and is not eligible for the exception in §40-18-35(b)(3) and §40-18-24(e). If another category of receipts is greater than interest/intangible receipts, the recipient related member is deemed to be primarily engaged in an activity other than the financing of related members or the management of intangibles and satisfies part of the exception listed in §40-18-35(b)(3) and §40-18-24(e).

**NOTE: If the taxpayer is not primarily engaged in the financing of related members and the management of intangibles, it qualifies for only part of the exception listed in §40-18-35(b)(3) and §40-18-24(e). In order to qualify for the exception in full an informed officer must affirm that the transaction(s) giving rise to the interest/intangible expenses does not have as a principal purpose tax avoidance (which includes the avoidance of a meaningful amount of Alabama tax) by signing the affidavit portion of Schedule PAB.**

**11 – Determining Your Exempt Amount**

To determine the taxpayer’s deductible amount of interest/intangible expenses, enter the greater of Lines 5g, 6 or 10a/10b.

12 and 13 should be completed by entering the total for all intangible/interest payments made to related members on Line 12 (sum of Line 4 for each related member recipient) and the total exempt amount on Line 13 (sum of Line 11 for each related member recipient). Subtract Line 13 from Line 12 and enter the difference on Line 1, Schedule A, Form 65 or Line 2, Schedule A, Form 20S.