

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

Pursuant to §40-18-35(b) and Rule 810-3-35-.02, related member interest and/or intangible expenses must be added back to the taxpayer's apportionable income, unless the taxpayer "shows" or "establishes" that it satisfies an exception described in §40-18-35-(b) and Rule 810-3-35-.02. If the taxpayer incurred related member intangible and/or interest expenses that were not added back to apportionable income on its Alabama Corporate Income Tax Return, it must establish that it satisfies an 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).

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) and §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).

General Instructions

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

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

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

- The jurisdiction(s) where the recipient related member is "subject to tax" and income is not being allocated. 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.**
- The amount of expense subject to apportionment that the taxpayer paid to the recipient related member but is not required to add back pursuant to §40-18-35(b)(1).
- Enter the sum of all recipient related member apportionment factors for the jurisdictions listed on Line 5a.
- Multiply the sum of all apportionment factors on Line 5c by the amount of expense subject to apportionment on 5b.
- 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. Also enter the jurisdictions where the expense is allocated in the blank line provided. If necessary, attach a statement.
- Enter the sum of amounts apportioned to jurisdiction(s) on Line 5d and the amounts allocated to jurisdiction(s) on Line 5e.

Section 6 – Application for Exception Pursuant to Section 40-18-35(b)(2) and Section 40-18-35(b)(4)

• **Section 40-18-35(b)(2)** – Application for the exception provided in Section 40-18-35(b)(2) must be made in the following prescribed manner. Applicants must follow the statutory steps provided in Section 40-18-35(b)(2) and 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 pursuant to Section 40-18-35(b)(2) and will not be accepted. See Section 40-18-35(b)(3).

• **Section 40-18-35(b)(4)** – Application for the exception provided in Section 40-18-35(b)(4) 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)

To establish that the related member intangible/interest expenses qualify for the exception in §40-18-35(b)(3), 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).

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.

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). 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).

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). In order to qualify for the exception in full, the taxpayer must also sign Schedule AB.

NOTE: To be eligible for the exception listed in §40-18-35(b)(3), an informed corporate 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).

11. – Determining Your Exempt Amount

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

12. Enter the amount of Interest Expense Disallowed on the Federal Return Pursuant to IRC 163(j). This should be calculated on a pro rata basis for each recipient related member. Example: Taxpayer pays total interest expense of \$10,000,000 including \$5,000,000 to related party C. Taxpayer incurs a \$2,000,000 "net interest limitation" (taxpayer was able to deduct \$8,000,000 of interest expenses). To de-