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**Subject: First Decision Concerning Application of Intangible Expense Add-Back Statute**  
**Date: February 2, 2007**

To Our Clients and Friends:

A case of first impression has been decided regarding the validity of an intangible expense add-back statute. By way of background, an increasing number of states have addressed intercompany pricing issues by statutorily disallowing certain intercompany expenses and excluding certain intercompany income. These "anti-passive investment company" provisions are usually quite detailed and complex, and generally apply to transactions with investment or holding companies, rather than transactions with operating companies. The typical legislation generally disallows otherwise deductible interest expense and intangible expenses, such as royalties, resulting from certain related-party transactions.

The typical legislation also generally contains exceptions whereby taxpayers may overcome intercompany expense disallowance adjustments in certain instances. However, these exceptions are often burdensome and confusing for taxpayers to meet. In VFJ Ventures, Inc. v. Alabama Department of Revenue, Alabama Circuit Court, Docket No. CV-03-3172, January 24, 2007, the issue was whether the Department could require the taxpayer to include in taxable income certain royalties paid to two related entities (which were Delaware holding companies). The relevant provisions of the Alabama statute required corporations, when computing their taxable income, to add back otherwise deductible intangible expenses and costs directly or indirectly paid, accrued or incurred to one or more related members unless certain exceptions applied. Add-back was not required if the corporation established that the add-back adjustments were unreasonable.

The court held that the add-back was unreasonable and not required because it effectively denied the taxpayer a deduction for a necessary cost of doing business in Alabama, thereby resulting in a calculation of taxable income that included income fairly attributable to other states. The related entities to which the payments were made were not sham or shell corporations. There were several business purposes for their creation and continued viability. The related entities carried on substantial activities that were vital to the business operations of the affiliated group. The taxpayer had a business purpose for making the royalty payments - it needed the use of the trademarks in its operations. The payments also had economic substance - they were made in cash and conferred on the taxpayer the right to use the trademarks. The court concluded that the add-back was unreasonable because the taxpayer's royalty payments were not abusive - they had economic substance and business purpose - and represented real and necessary costs of doing business in Alabama. To disallow the deductions would distort the amount of the taxpayer's income fairly attributable to Alabama. The court noted that its conclusion was not altered by the fact that the transactions may have been motivated by tax considerations.

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If you have any questions regarding the within, or any other state and local tax matters, please do not hesitate to contact me.

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