

THE GENETELLI CONSULTING GROUP
State and Local Tax Services
431 FIFTH AVENUE
NEW YORK, NY 10016

(212) 684-4111
FACSIMILE: (212) 213-1020
EMAIL: rgetelli@genetelli.com

**Subject: Reversal of First Decision Concerning Application of Intangible Expense
Add-Back Statute**
Date: February 26, 2008

To Our Clients and Friends:

The first case addressing the validity of an intangible expense add-back statute has been reversed. In Alabama Department of Revenue v. VFJ Ventures, Inc., Court of Civil Appeals of Alabama, Docket No. 2060478, February 8, 2008, the issue was whether the Department could require the taxpayer to include in taxable income certain royalties paid to two related entities (Delaware holding companies). The relevant provisions of the Alabama statute required a corporation, when computing its 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 were met.

One of the exceptions provided that an add-back was not required if the corporation established that the add-back adjustments were unreasonable. This unreasonableness exception was interpreted as addressing whether the add-back statute resulted in taxation that was out of proportion to the corporation's activities in Alabama. No specific evidence was presented showing a possible distortion of VFJ's income if the add-back statute was applied, or indicating that the amount of tax to which VFJ was subject under the add-back statute was out of proportion to VFJ's activities in Alabama. Given the lack of evidence, the court could not conclude that the application of the add-back statute to VFJ was unreasonable.

Another of the exceptions provided that an add-back was not required if the related members (the Delaware holding companies) reported and included the royalty payments received from the taxpayer corporation (VFJ) in income for purposes of a tax on net income in another state (in this case, North Carolina). This "subject-to-tax" exception was interpreted to apply on a post-apportionment basis, rather than a pre-apportionment basis. Since the related members (the Delaware holding companies) were only taxed by North Carolina on .0019% and .0027%, respectively, of their federal taxable incomes (i.e., the amounts apportioned to North Carolina by the Delaware holding companies), VFJ could not invoke the "subject-to-tax" exception with respect to income that was not apportioned to North Carolina by the Delaware holding companies.

In response to constitutional challenges (Due Process and Commerce Clause), the court held that disallowing a deduction for an expense paid by VFJ did not constitute a tax on the entities to whom it paid that expense (the Delaware holding companies). Moreover, the court held that VFJ did not demonstrate that the add-back statute resulted in taxation of income not fairly attributable

THE GENETELLI CONSULTING GROUP
State and Local Tax Services

to Alabama. Finally, the court held that the add-back statute did not discriminate against interstate commerce on the ground that the "subject-to-tax" exception resulted in differential tax treatment between states.

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

Richard W. Genetelli
The Genetelli Consulting Group
State and Local Tax Consultants
431 Fifth Avenue, 3rd Floor
New York, NY 10016
Tel: (212) 684-4111
Fax: (212) 213-1020
<http://www.genetelli.com>