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**Subject: Planning to Minimize Expense Disallowance Adjustments**  
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To: Our Clients and Friends

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. For example, recent legislation in Alabama (effective July 7, 2006) provides that taxpayers may deduct interest expense and intangible costs paid to related parties if the payees passed through the payments to unrelated third parties, subject to the following three limitations:

1. If the payee receives more interest or intangible income than is passed through to unrelated third parties, the payor may only deduct the portion that is passed through.
2. The passed through interest expense and intangible costs must be added back to the extent the interest or royalty rate charged the payor exceeds an arm's length rate.
3. A portion of the passed through interest expense must be added back if the payor's debt over asset percentage exceeds the consolidated unrelated third party debt over asset percentage of the payor's federal affiliated group.

Statutory disallowance issues are becoming more commonplace on audit as audit cycles begin to include years where the relevant legislation has been in effect. Therefore, it is more important than ever for taxpayers to be familiar with the various statutory disallowance provisions in order to avoid a costly tax surprise. Moreover, taxpayers seeking to establish exceptions to expense disallowance adjustments are advised to review the relevant intercompany transactions up front, since it may be too late to implement the appropriate measures once the record is set.

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The Genetelli Consulting Group has valuable experience in addressing statutory disallowance issues, and developing planning measures that position taxpayers to meet exceptions to expense disallowance adjustments. If you have any questions regarding statutory disallowance issues, or would like help in evaluating whether exceptions to expense disallowance adjustments can be established, please do not hesitate to call.

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