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**Subject: First Decision Regarding Application of Intangible Expense Add-Back Statute
Affirmed**
Date: October 6, 2008

To Our Clients and Friends:

On September 19th, the Supreme Court of Alabama (in VFJ Ventures, Inc., v. Surtees, No. 1070718) affirmed in its entirety the holding of the Court of Civil Appeals of Alabama (Alabama Department of Revenue v. VFJ Ventures, Inc., No. 2060478, February 8, 2008) that addressed the validity of the Alabama intangible expense add-back statute. 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. Given a 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. Accordingly, 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 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.

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It should be noted that the Alabama intangible expense add-back statute was amended on June 9th. Included among the amendments was a clarification that the “subject-to-tax” exception does not apply to any portion of income that is not attributed to a taxing jurisdiction, as determined by the jurisdiction’s allocation and apportionment provisions.

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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