



MULTISTATE INCOME/FRANCHISE TAX

Alabama opinion allows intercompany interest expense exception under income tax addback statute Tax Alert

Overview

On July 28, 2022 the Alabama Tax Tribunal (“Tribunal”) issued an [opinion](#) overturning an Alabama Department of Revenue (“Department”) audit adjustment to a taxpayer’s net operating losses (“NOLs”) related to the add back of intercompany interest expenses paid to a related party based in a foreign country.

This Tax Alert summarizes the Tribunal’s opinion and provides some taxpayer considerations.

Tribunal opinion

Alabama income tax laws require that taxpayers that pay interest or intangible expenses to a related party and deduct those expenses for federal tax purposes must add those expenses back to Alabama taxable income unless an exception is met. Ala. Code § 40-18-35(b)(1) specifically states:

For purposes of computing its taxable income, a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members, except to the extent the corporation shows, upon request by the commissioner, that the corresponding item of income was in the same taxable year:

- a. Subject to a tax based on or measured by the related member's net income in Alabama or any other state of the United States, or
- b. Subject to a tax based on or measured by the related member's net income by a foreign nation which has in force an income tax treaty with the United States if the recipient was a "resident" (as defined in the income tax treaty) of the foreign nation. For purposes of this

section, subject to a tax based on or measured by the related member's net income means that the receipt of the payment by the recipient related member is reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor. Any portion of an item of income that is not attributed to the taxing jurisdiction, as determined by that jurisdiction's allocation and apportionment methodology or other sourcing methodology, is not included in income for purposes of a tax on net income and, therefore, shall not be considered subject to a tax. That portion of an item of income which is attributed to a taxing jurisdiction having a tax on net income shall be considered subject to a tax even if no actual taxes are paid on such item of income in the taxing jurisdiction by reason of deductions or otherwise.

The taxpayer in this case claimed an exception to Alabama's addback statute on its corporate returns, claiming that the interest expense paid to its related member in Ireland was an allowable deduction under state law because one of the exceptions to the addback rule was met. On audit, the Department disagreed, denied the deduction, and adjusted the taxpayer's NOLs accordingly. The taxpayer protested the assessment.

In its opinion, the Tribunal held in the taxpayer's favor, finding that certain interest paid to a related member in Ireland should be excepted from Alabama's intercompany expense addback statute. The Tribunal held that the interest payments were subject to tax on the related member's net income tax return filed in Ireland. In its decision, the Tribunal considered whether these interest payments were attributed to Ireland despite being deducted by the Ireland entity on its return after the Ireland entity subsequently paid the interest to affiliates in Luxembourg. The opinion held that Alabama's addback statute subject to tax exception applied because the interest income that the related member received from the taxpayer "shall be considered subject to a tax even if no actual taxes are paid on such item of income in the taxing jurisdiction by reason of deductions or otherwise."

According to the decision, the interest payments made by the taxpayer to the related member were attributed to Ireland according to that nation's sourcing methodology and "fit squarely within the subject-to-tax exception to Alabama's add-back statute." Accordingly, the Tribunal held that the Department must recalculate the taxpayer's underlying state corporate income tax net operating losses and carryforward amounts in accordance with the decision. At this time, it is not known whether the Department will appeal the Tribunal's decision.

Considerations

Similarly situated taxpayers should consult their tax advisors to see if they may likewise qualify for this exception to Alabama's addback statute. Furthermore, taxpayers protesting preliminary assessments or appealing final assessments based on similar facts should consult their tax advisor to see if there may now be an opportunity to resolve those matters with the Department.

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