

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of )  
 ) DOCKET NO. 25612  
[Redacted], )  
 )  
Petitioner. ) DECISION  
\_\_\_\_\_ )

BACKGROUND

On February 21, 2013, the Audit Division (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioner) proposing income tax and interest for taxable years ending January 1, 2010, December 31, 2010, and December 30, 2011, in the total amount of \$10,783. On March 19, 2013, the Petitioner filed a timely protest. The file was transferred to the Legal/Tax Policy Division on April 4, 2013, for resolution. On July 31, 2013, the Commission sent the Petitioner a letter that explained the methods available for redetermining an NODD. The Petitioner is a Subchapter S Corporation that has filed a composite return in Idaho and paid the owner’s tax liability at the entity level.

ISSUE

1. Whether the Petitioner is barred from subtracting the separately stated expenses for increasing research activities when computing the Idaho composite income tax liability of the nonresident owners.

LAW AND DISCUSSION

Idaho Code § 63-3022L<sup>1</sup> allows a pass-through entity to pay the Idaho income tax liability of nonresident owners, also known as a composite return. The election applies to: “The

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<sup>1</sup> Idaho Code §63-3022L was amended in 2010 and again in 2011. The changes made with those amendments do not impact this issue.

share of any income, loss, deduction or credit of a pass-through entity required to be included on such individual's Idaho return.”

Internal Revenue Code (IRC) §162 Trade or Business Expenses. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the year in carrying on the trade or business...

The expenses incurred for research are deductible under IRC §162.

“IRC § 280C; Certain expenses for which credits are allowable.

(c) Credit for increasing research activities.

(1) In general.

No deduction shall be allowed for that portion of the qualified research expenses (as defined in section 41(b)) or basic research expenses (as defined in section 41(e)(2) ) otherwise allowable as a deduction for the taxable year which is equal to the amount of the credit determined for such taxable year under section 41(a) .  
Underline added.

There is an election for a reduced [Redacted] credit of 13 percent instead of 20 percent of the qualified research expenses. A taxpayer taking the reduced federal credit (13%) is not required to reduce the related expenses deducted by the amount of the credit.

“IRC 280 C (3) Election of reduced credit.

(A) In general. In the case of any taxable year for which an election is made under this paragraph-

(i) paragraphs (1) and (2) shall not apply, and

(ii) the amount of the credit under section 41(a) shall be the amount determined under subparagraph (B) .”

The Petitioner in this case did take the reduced 13 percent [Redacted] credit and therefore does not have to reduce the expenses that they can deduct.

IRC 59(e)(2) Qualified expenditure For purposes of this subsection, the term “qualified expenditure” means any amount which, but for an election under this subsection, would have been allowable as a deduction (determined without regard to section 291) for the taxable year in which paid or incurred under –  
Underline added.

These research expenses are allowable as a deduction. The relevant portion of Income Tax Administrative Rule 291, in effect for the years 2009 and 2010, prior to the temporary rule issued by Resolution 10-5 on July 21, 2010 is as follows:

Idaho Income Tax Administrative Rule 291.04. Deductions That Are Subject to Limitations or Elections by Individuals. A pass-through entity is not allowed to deduct items that are subject to limitations or elections at the individual level. Examples of such items include the Section 179 deduction, research and experimental expenses, mining exploration and development costs, pre-productive period expenses, and passive activity losses. Individuals may not bypass limitations on deductions by electing to have the pass-through entity pay the tax.

This rule was relied upon by Audit to disallow the subtraction of the research expenses in calculating the composite tax liability.

The Commission issued Resolution 10-05 on July 21, 2010, as a temporary rule under Idaho Code § 67-5226, removing paragraph 4 from Rule 291. The stated purpose of Resolution 10-05 was to allow deductions in the computation of a composite tax liability under Idaho Code § 63-3022L that “would be allowed if the individual filed an Idaho individual income tax return, unless such deduction is specifically denied by Idaho Law...” This temporary rule applied to all open years as of July 21, 2010, which included the taxable years 2009 and 2010.

Following is the relevant portion of Idaho Income Tax Administration Rule 291, passed by the Legislature on April 7, 2011, and effective for the taxable year 2011. The previous language in paragraph 4 was left out as it had been in the temporary rule.

Rule 291. 03. Deductions. Pass-through entities paying the tax under Section 63-3022L, Idaho Code, are not entitled to claim the following deductions on behalf of an individual.

- a. Capital Loss. As provided in Section 63-3022(i), Idaho Code, S corporations and partnerships are not allowed to carry over or carry back any capital loss provided for in Section 1212, Internal Revenue Code.
- b. Net Operating Loss. As provided in Section 63-3022(i), Idaho Code, S corporations and partnerships are not allowed to carry over or carry back any net operating loss provided for in Section 63-3022(c),

c. Idaho Capital Gains Deduction. As provided in Section 63-3022H, Idaho Code, the Idaho capital gains deduction may only be claimed by individual taxpayers on an individual income tax return.

d. Informational Items. Amounts provided to owners of pass-through entities and beneficiaries of trusts and estates on the federal Schedule K-1 that are informational only may not be used as a deduction in computing the taxable income reportable under Section 63-3022L, Idaho Code. Informational items include the domestic production activities information and net earnings from self-employment.

e. Items Not Deductible Under the Internal Revenue Code. A deduction is not allowed for items disallowed under the Internal Revenue Code. For example, a deduction is not allowed for items disallowed as a deduction in Sections 162(c) and 262 through 280E, Internal Revenue Code, unless specifically allowed by Idaho law. Items allowed by Idaho law include expenses related to tax-exempt income under Section 265, Internal Revenue Code, which are allowed to be deducted as a result of Section 63-3022M, Idaho Code.

f. Items Not Reported as a Pass-Through Deduction. Amounts not reported from the pass-through entity to the pass-through owner are not allowed as a deduction under Section 63-3022L, Idaho Code. These include:

i. The standard deduction;

ii. Personal exemptions;

iii. Itemized deductions that result from activity of the pass-through owner. For example, a deduction is not allowed for charitable contributions made personally by the pass-through owner, but is allowed for the pass-through owner's share of charitable contributions made by the pass-through entity.

04. Double Deductions Disallowed. A pass-through owner may not deduct amounts that previously have been deducted by a pass-through entity paying the tax on his behalf. If the pass-through owner files an Idaho individual income tax return reporting federal taxable income that includes amounts previously deducted by a pass-through entity on his behalf, the pass-through owner must add back the duplicated deduction amounts in computing his Idaho taxable income on his individual income tax return.

If they had distributed the income to the individual owners, the expenses would have been distributed in proportion to each owner's income percentage and available for the owners to use on their non-resident Idaho returns. Individuals receiving a distributive share of research expenses have an option of fully expensing it or amortizing it over a longer period.

Petitioner's position in relevant parts: "The research and development expenditures that are being disallowed by the Idaho State Tax Commission are included as a component of the taxpayer's individual [Redacted]taxable income for the 2009, 2010, and 2011 tax returns." "Though we do

agree Code Section 63-3022L does not include a provision for the deduction of research and development expenditures from taxable income, it also does not include a provision for the addition to taxable income. We are not attempting to adjust the treatment of the expenditures in any way on the Idaho return. The research expenses were a component of [Redacted] taxable income for the 2009, 2010, and 2011 tax years, required to be included in the nonresident owner's individual income tax returns. They were, therefore, used as a component of Idaho taxable income for each of those years, per Idaho's Code Sections."

Audit position: "Pursuant to Idaho Code § 63-3022L, certain items are allowed to be deducted from [Redacted] taxable income in order to arrive at Idaho taxable income. In addition, Idaho Income Tax Administrative Rule 35.01.01.291.04, prior to Resolution 10-05, explicitly stated a pass-through entity is not allowed to deduct items that are subject to limitations or elections at the individual level, including research and experimental expenses..."

#### CONCLUSION

The temporary rule, in Resolution 10-05, removing paragraph 4 from Rule 291 was issued on July 21, 2010, applying to the 2009 and 2010 tax years, and the final version of Rule 291, effective in 2011, no longer disallowed the use of separately stated pass-through deductions. Therefore, we conclude that the entity can subtract the research expenses in calculating the nonresident owner's income tax liability for those years.

Since the entity took the reduced credit under IRC § 280C (3), the full amount of the research expenses are available as an expense. The nonresident owners are entitled to their distributive share of the federal credit for increasing research activities and the full deduction of the related expenses in arriving at their Idaho income tax liability paid by the Petitioner.

THEREFORE, the Notice of Deficiency Determination dated March 19, 2013, and directed to the [Redacted] is hereby CANCELLED.

An explanation of the Petitioner's right to appeal this decision is enclosed.

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2014.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2014, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.  
  
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