

General Information Letter: No subtraction modification is allowed for research and development expenditures not deducted in computing federal taxable income.

March 2, 2000

Dear:

This is in response to your letter dated January 26, 2000, which states as follows:

We are responding on behalf of the above named taxpayer to the enclosed notice dated November 13, 1999. The notice reduces to zero the amount claimed in "other subtractions" on line 5f of the 1998 IL-1120-ST tax return.

The amount listed under "other subtractions" (\$5,420,237) was detailed on the enclosed Statement 1 with the return and is comprised of Subpart F income (\$37,691 from xxxxxxxxxxxxxx and \$19,904 from xxxxxxxxxxxxxxxxxxxxxxxxxxxxxx) and Research & Developmental Expenditures (\$5,362,642).

The subtraction for Subpart F income should be allowed. The instructions for Form IL-1120-ST state that Subpart F income is allowed as a subtraction under §[35] ILCS 5/203.

The subtraction for research and developmental expenditures should also be allowed. The taxpayer has not taken a credit for increasing research activities. The taxpayer has subtracted from federal ordinary taxable income the amount of qualified research expenditure for 1998. These expenditures are separately stated on Schedule K, line 16 of form 1120S and are not included in the calculation of ordinary income reported on Form 1120S, Schedule K, Line 1. These expenditures are ordinary business expenditures used to determine the individual's federal adjusted gross income. Accordingly, these should be allowed as a deduction on Form IL-1120-ST.

Consequently, we believe our return to be correct, and respectfully request that the taxpayer's Illinois records be adjusted accordingly.

RULING

For the reasons explained below, the return for the above named taxpayer has not been filed correctly. The Department properly issued a notice of mathematical error (BTR-76). However, based upon your letter, the Department will adjust the taxpayer's account to reflect a reduction in unmodified base income reported on line 5 of Part IA, and Line 1 of Part I of Form IL-1120-ST by \$5,362,642, and an increase in the amount allowed as "other subtractions" on Line 5f from \$0 to \$57,595.

The taxpayer's return claims as a subtraction modification in the computation of Illinois base income an amount representing "Research and Developmental Expenditures." Section 203(h) of the Illinois Income Tax Act ("the IITA"; 35 ILCS 5/101 et seq.) states as follows:

Except as expressly provided by this Section there shall be no modifications or limitations on the amounts of income, gain, loss or deduction taken into account in determining gross income, adjusted gross income or taxable income for federal income tax purposes for the taxable year, or in the amount of such items entering into the computation of base income and net income under this Act for such taxable year, whether in respect of property values as of August 1, 1969 or otherwise.

Section 203(b)(2) of the IITA does not contain a provision allowing for the subtraction of research and developmental expenditures in the computation of Illinois base income. Accordingly, such amounts may not be reported on line 5f of Form IL-1120-ST.

Section 203(e)(2)(G) of the IITA defines "taxable income" in the case of a Subchapter S corporation.

[A] Subchapter S corporation for which there is in effect an election for the taxable year under Section 1362 of the Internal Revenue Code, the taxable income of such corporation determined in accordance with Section 1363(b) of the Internal Revenue Code, except that taxable income shall take into account those items which are required by Section 1363(b)(1) of the Internal Revenue Code to be separately stated.

Research and experimental expenditures must be separately stated on Line 16 of Schedule K on Form 1120S for federal income tax purposes. For Illinois income tax purposes, then, such amounts must be reflected in the computation of federal taxable income for purposes of determining Illinois base income, and not as a subtraction modification.¹ Accordingly, such amounts should have been reflected on Line 4e of Part IA of Form IL-1120-ST, rather than on Line 5f of Part I.

IITA section 1501(a)(12)(B) provides that the term "mathematical error" includes "entries on wrong lines." Thus, the Department correctly issued the Taxpayer Notification BTR-76.

Sincerely,

Brian L. Stocker
Staff Attorney (Income Tax)

¹ Note also that the federal tax law allows a deduction for "research and experimental expenditures" and not for "research and developmental expenditures." (IRC §174) The distinction is an important one. (See Treas. Regs. 1.174-2(a)). The statement attached to the taxpayer's return here identified amounts as representing "research and developmental expenditures." The Department will assume that the amounts so identified are properly deductible under IRC section 174.