

October 18, 2004

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Dear Mr. Davis and Ms. Watson Cook:

Thank you for your letter on behalf of the Iowa State Bar Association Tax Section. In your letter, you provided counsel and requested that the Department of Revenue allow taxpayers to treat depreciation adjustments authorized by legislation passed last month by the Iowa General Assembly as accounting method changes. I am grateful to you and others who have provided counsel about these important issues. My goal is identical to yours: to implement these changes with the greatest ease and convenience for taxpayers and their representatives.

In response, I convened a group within our department to review your comments and recommendations. Additionally, I consulted with private sector attorneys and tax professionals for their informal counsel. Ultimately, the department maintains its position that the legislation as passed allows no alternative but to require that amended returns must be filed to receive the benefit of the change in HF 2581.

The department's position is strongly supported by the Iowa Supreme Court decision in First National Bank of Ottumwa v. Bair, 252 N.W. 2d 723 (Iowa 1977). The issue in this case involves whether a deduction allowed on a federal tax return should also be reflected in the computation of Iowa franchise tax. The Court was interpreting the meaning of Iowa Code Section 422.35, which provided in relevant part:

The term 'net income' means the taxable income less the net operating loss deduction, both *as properly computed for federal income tax purposes* under the Internal Revenue Code of 1954, with the following adjustments: (emphasis supplied)

The Court determined that several rules of statutory construction applied to the examination of these statutory provisions, as noted below:

Where the language is clear and plain, there is no room for construction. Iowa Nat. Indus. Loan Co. v. Iowa State Dep't of Revenue, 224 N.W.2d 437, 440 (Iowa 1974); In re Johnson's Estate, 213 N.W.2d 536, 539 (Iowa 1973). We must look at what the legislature said, rather than what it should or might have said. Rule 344(f)(13), Rules of Civil Procedure; Kelly v. Brewer, 239 N.W.2d 109, 113-114 (Iowa 1976).

The Court applied these rules of construction and considered Iowa Code § 422.35, indicating:

Stripped to language material here, §§ 422.60, 422.61(4) and 422.35 simply provide the "net income" upon which the bank's franchise tax is to be computed is the "taxable

income... *as properly computed for federal income tax purposes.*" These words plainly dictate that the starting point for computation of net income for Iowa franchise tax purposes is the taxable income figure reported on the federal income tax return.

...

We believe the director is incorrect in contending a literal interpretation of these statutes would result in absurd, impractical or unreasonable consequences. The result is practical. The taxpayer is permitted to merely lift the figures off the federal return and transfer them to the Iowa franchise tax return. The Department of Revenue receives the benefit of the regulations and interpretations of the federal agency.

It is the department's position that this case clearly supports the position that since the 50% bonus depreciation and increased section 179 expensing is deducted in computing federal taxable income on the 2003 federal income tax return, it must also be deducted on the 2003 Iowa income tax return, and this can only be accomplished by the filing of an amended return.

Your letter indicates that Iowa Rule 701—41.2(422) provides the authority for the department to consider the change in HF 2581 as a change in accounting method, and would provide for the depreciation adjustment to be made on the 2004 Iowa return.

Iowa Rule 701—41.2(422) states as follows:

701—41.2(422) Federal rulings and regulations. In determining whether "taxable income," "net operating loss deduction" or any other deductions are *computed for federal tax purposes* under, or have the same meaning as provided by, the Internal Revenue Code, the department will use applicable rulings and regulations that have been duly promulgated by the commissioner of internal revenue, unless the director has created rules and regulations or has exercised discretionary powers as prescribed by statute which calls for an alternative method for determining "taxable income," "net operating loss deduction" or any other deduction, or unless the department finds that an applicable internal revenue ruling or regulation is unauthorized according to the Iowa Code. (emphasis supplied)

The department contends that this rule states that Iowa will use federal rulings and regulations in determining how federal taxable income is computed. As noted above, Iowa law requires that the starting point for Iowa tax purposes is federal taxable income. Therefore, the department only has the authority to make accounting method changes for Iowa only adjustments, such as the examples of the federal tax deduction and municipal interest that were noted in your letter. The department contends that HF 2581 provided for an additional deduction for Iowa income tax purposes relating to depreciation, and did not provide for an accounting method change for Iowa tax purposes.

In addition, the department does not agree that it has the authority under section 1.446-1(e)(3) of the Code of Federal Regulations to issue rulings regarding the timing of change of accounting method adjustments. First, these federal regulations give the authority only to the Commissioner of the Internal Revenue Service, not to the Director of the Iowa Department of Revenue. Also, as discussed above, taxpayers are required to use federal taxable income as the starting point on the Iowa income tax return, so the change of accounting method issue is not relevant for Iowa tax purposes.

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Finally, the department notes that the Iowa General Assembly has the authority to make a legislative change to allow the depreciation adjustment to be made on the 2004 Iowa return in lieu of amending the 2003 Iowa return. The department understands that there are significant administrative costs associated with the preparation and processing of amended returns, both to taxpayers and to the department. In fact, it might be wise for tax preparers to hold off filing amended returns pending any possible change by the 2005 Iowa legislature, especially since there is a three year statute of limitations for taxpayers to file amended returns to claim a refund. However, absent a legislative change, the Department has no authority to implement the depreciation changes as you suggest.

Again, I have given these matters a great deal of thought and carefully weighed counsel from a variety of sources. I am sincerely grateful for your letter and would be pleased to meet with you should you wish to discuss any of these issues further. Thank you very much.

Sincerely,

Michael Ralston  
Director

cc: The Honorable Danny Carroll  
Joe Royce, Esq.  
Dwight L. Dinkla, Esq.