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Michael D. Ralston, Director  
Iowa Department of Revenue  
Hoover State Office Building  
Des Moines, Iowa 50319

**VIA Fax**

We are writing you as on behalf of the Iowa Bar Association Tax Section Council to urge you to utilize the powers of your office to draft procedures allowing Iowa Taxpayers to treat the HF 2581 depreciation adjustments as Iowa only Accounting Method Changes. We believe Iowa taxpayers are entitled to the option of taking the HF 2581 depreciation adjustments by either amending their 2003 tax returns or by treating the HF 2581 adjustment as an Accounting Method Change adjustment taken in the year of the Accounting Method Change - 2004. We believe the Director of the Iowa Department of Revenue possesses authority to authorize HF 2581 Accounting Method Change adjustments to be deducted in 2004.

It is clear HF 2581 designates changes which allow Iowa taxpayers to adjust the starting point for calculating 2003 Iowa Income to equal the amount reflected on their 2003 federal adjusted gross income calculated by utilizing the \$100,000 Section 179 immediate expensing provision and by utilizing the 50% bonus depreciation allowed for the purchase of original use assets. Additionally, it is also clear that the changes proscribed by HF 2581 meet the federal definition of an Accounting Method Change. As such, the Director of the Iowa Department of Revenue possesses administrative powers under IAC Section 701-41.2(422) to adopt IRS regulations or rulings as appropriate for determining Iowa taxable income. Taxpayers also possess the right to file a form 3115 Change of Accounting Method application and deduct the HF 2581 adjustment pursuant to Internal Revenue Code Section 481.

We appeal to you to utilize the powers of your office for the benefit of both Iowa Taxpayers and the State of Iowa by issuing a policy letter concurring that the HF 2581 adjustments represent an Iowa only Change of Accounting Method and that the resulting income adjustment can be included on a taxpayers 2004 tax return as a Method of Accounting Change Adjustment. Allowing a 2004 Method of Accounting Adjustment would provide Iowa taxpayers the option of amending 2003 tax returns or deducting the HF 2581 adjustment in 2004.

Allowing a 2004 Method of Accounting adjustment will save both the Iowa Department of Revenue and Iowa taxpayers the significant administrative costs associated with preparing and processing 2003 amended returns. It will also allow Iowa to avoid paying statutory interest on the HF 2581 tax reductions as no interest will be available to taxpayers who claim the deduction as a method change adjustment on a 2004 return.

We have attached to this letter a legal brief summarizing the statutory authority authorizing the Director of the Iowa Department of Revenue to issue guidance as to Iowa only Change in Accounting Method adjustments. If we can be of any assistance or if you have any questions, please do not hesitate to contact us.

Sincerely,

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Member  
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CC Danny Carrol - Speaker Pro Tem Iowa Legislature

GAD:ls  
Attachment

## Iowa Administrative Code Section 701-41.2(422)

Iowa Administrative Code Section 701-41.2(422) provides the following:

**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.

By deleting extraneous material this regulation can be restated as follows:

In determining whether . . . 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 . . . any other deduction, or unless the department finds that an applicable internal revenue ruling or regulation is unauthorized according to the Iowa Code

The Iowa Department of Revenue **must** utilize IRS definitions, rulings and regulations to define Change in Accounting Method Adjustments and related procedures. The director of the Iowa Department of Revenue has not created rules and regulations or exercised discretionary powers defining Change in Accounting Method Adjustments. Likewise, the Iowa Code does not prohibit Change in Accounting Method Adjustments. Therefore, the Iowa Department of Revenue must look to Internal Revenue Code analysis to define Change in Accounting Method Adjustments and related procedures. Under federal law, taxpayers can either adopt accounting methods initially, or can adopt them after previously adopting a permissible or impermissible method accounting. Under federal Revenue Procedures, taxpayers are typically allowed to adjust income in the year of the Change in Accounting Method, or over a period of years under IRC section 481.

It is clear that HF 2581 provides a new method of accounting for 2003 depreciation. However, the legislation does not prohibit alternatively deducting the resulting adjustment as an Accounting Method Change Adjustment. Because Iowa law does not prohibit nor define Accounting Method Changes, the director must look to federal law for guidance. The Internal Revenue Code, regulations, and related rulings discussed below clearly allow the HF 2581 adjustments to be alternatively deducted in future periods as a Change of Accounting Method Adjustments.

## **The Iowa Department of Revenue has Frequently Provided Guidance on Iowa Only Method of Accounting Change Adjustments**

The Iowa Department of Revenue has previously required Section 481(a) adjustments to be computed on the basis of Iowa only Method of Accounting Adjustments. In 1991 the Iowa State Board of Tax Review required a taxpayer going from the cash method of accounting to the accrual method of accounting to compute a Section 481(a) adjustment for Iowa only municipal bond interest.<sup>1</sup> The Department also permitted an Iowa only Change of Accounting Method Deduction for federal taxes in an October 7, 1997 policy letter. Both of these situations are examples where the Director of the Iowa Department of Revenue utilized federal Change in Accounting Method authority to adopt Iowa only Method of Accounting Change Adjustments.

## **The Depreciation Changes Authorized by HF 2581 Represent an Iowa Only Method of Accounting Change**

Iowa statutes and regulations do not address rules and definitions for accounting methods and related changes. Therefore, it is necessary to look to the Internal Revenue Code for guidance pursuant to Iowa Administrative Code Section 701-41.2(422).

Internal Revenue Code Section 446 and its related regulations deal with Accounting Methods and Changes in Accounting Methods. In general, taxpayers elect an accounting method by simply applying the selected method when computing income on an initial return or in the **first year the item occurs**. The term accounting method refers to not only the overall accounting method used by the taxpayer, but also the treatment of any item of income or deduction including depreciation.<sup>2</sup> In fact, depreciation method changes are a frequent source of accounting method change revenue procedures.<sup>3</sup> Further, changes in depreciation methods are specifically cited in the regulations as a change of accounting method.<sup>4</sup>

Iowa taxpayers were forced to adopt a method of accounting for Iowa depreciation by application of Iowa law in effect when taxpayers filed their 2003 Iowa tax returns. This method of accounting prohibited the deduction section 179 depreciation deductions exceeding \$25,000 and prohibited the 50% immediate depreciation of certain original use assets. Iowa statute prescribed a method of accounting for these items as defined by IRC Section 446 and its regulations. The non deduction of these depreciation adjustments was not an “error” at the time a return was filed nor is it an “error” at the present time due to the fact Iowa taxpayers do not have to amend their returns. It is clear the pre HF 2581 Iowa depreciation rules represented a

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<sup>1</sup> See In the Matter of First National Bank, Ames issued December 31, 1991.

<sup>2</sup> Internal Revenue Regulation 1.446-1(a).

<sup>3</sup> See Rev. Proc. 2002-9; Rev. Proc 2002-54; and Rev. Proc. 97-27.

<sup>4</sup> Internal Revenue Regulation 1.446 1T(e)(2)(ii)(d)(2).

method of accounting.

### **The Iowa Department of Revenue Possesses Authority to Issue Rulings Regarding the Timing of Change of Accounting Method Adjustments**

Iowa statutes and regulations do not address rules and definitions regarding the timing of accounting method adjustments. Therefore, it is necessary to look to the Internal Revenue Code for guidance pursuant to Iowa Administrative Code Section 701-41.2(422).

The Director of the Iowa Department of Revenue possesses authority under section 1.446-1(e)(3) of the Code of Federal Regulations to issue a policy letter prescribing the timing of the HF 2581 depreciation change of accounting method adjustments. Revenue Regulation 1.446-1(e)(3) provides the following:

(3)(i) Except as otherwise provided under the authority of paragraph (e)(3)(ii) of this section, to secure the Commissioner's consent to a taxpayer's change in method of accounting the taxpayer must file an application on Form 3115 with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. To the extent applicable, the taxpayer must furnish all information requested on the Form 3115. This information includes all classes of items that will be treated differently under the new method of accounting, any amounts that will be duplicated or omitted as a result of the proposed change, and the taxpayer's computation of any adjustments necessary to prevent such duplications or omissions. The Commissioner may require such other information as may be necessary to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer agrees to the Commissioner's prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account. See section 481 and the regulations thereunder, relating to certain adjustments resulting from accounting method changes, and section 472 and the regulations thereunder, relating to adjustments for changes to and from the last-in, first-out inventory method. For any Form 3115 filed on or after May 15, 1997, see §1.446-1T(e)(3)(i)(B).

(ii) Notwithstanding the provisions of paragraph (e)(3)(i) of this section, the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

(iii) This paragraph (e)(3) applies to Forms 3115 filed on or after December 31, 1997. For other Forms 3115, see §1.446-1(e)(3) in effect prior to December 31,

1997 (§1.446–1(e)(3) as contained in the 26 CFR part 1 edition revised as of April 1, 1997).

(4) *Effective date*. [Reserved]. For further guidance, see §1.446(e)–1T(e)(4)(i) and (ii).

Further, Rev. Proc. 2002-9 and Rev Proc. 2002-54 allow taxpayers to deduct depreciation related accounting method changes in the year of the accounting method change.

### **Public Policy, Basic Equity and Common Sense Favor Allowance of a 2004 Method of Accounting Adjustment for the Additional HF 2581 Depreciation Adjustments**

The express purpose of the September 2004 special session of the Iowa Legislature was to promote economic growth in Iowa. While the HF 2581 legislation did specifically allow depreciation adjustments to be deducted in 2004, Iowa taxpayers and the State of Iowa are fortunate that depreciation related changes constitute a Change in Accounting Method. As such, the Director of the Iowa Department of Revenue possesses authority under the Internal Revenue Code to promulgate guidance related to the deduction of the accounting method change adjustment.

The argument that method of accounting change adjustments are improper because they move items of income and deduction from one year to another is untenable. We note that all method change adjustments necessarily move items of income or deduction from one tax period to another. We also note the basic unfairness of retroactively changing Iowa tax law months after the due date of the originally filed return.

Allowing Change of Accounting Method treatment for the HF 2581 adjustments would allow thousands of Iowa taxpayers to avoid filing 2003 amended tax returns. Likewise, the Iowa Department of Revenue would not have to hand process these amended returns. Method change treatment would avoid potential of litigation against the state by taxpayers who believe they have a statutory right to deduct a IRC section 481 Change of Accounting Method adjustments by filing a form 3115 Iowa only Change in Accounting Method application. Approval of Change in Accounting Method treatment would also eliminate the need for the Iowa legislature to readdress this issue. Finally, the State of Iowa would not have to pay statutory interest on 2004 HF 2581 Method of Accounting Change Adjustments.

For all of these reasons, we believe public policy, basic equity, common sense and most importantly statutory authority support allowing HF 2581 adjustments to alternatively be allowed as 2004 Change of Accounting Method Adjustments under IRC 446 and IRC 481. We pray that the Director of the Iowa Department of Revenue utilize the powers of that office to issue a policy letter allowing a 2004 deduction of the HF 2581 adjustments and providing guidance to Iowa taxpayers on the relevant procedures to claim the deduction.