

**OHIO BOARD OF TAX APPEALS**

Rich’s Department Stores, Inc.                    )  
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  )                    CASE NO. 2005-T-1609  
  )                    (PERSONAL PROPERTY TAX)  
  )  
  )                    DECISION AND ORDER  
  )  
  )  
  )                    Appeal Filed Mar. 5, 2009  
  )                    Ohio Supreme Court  
  )  
  )  
  )                    Appellee.

APPEARANCES:

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Entered February 3, 2009

Ms. Margulies, Mr. Eberhart, and Mr. Dunlap concur.

Rich’s Department Stores, Inc. (“Rich’s”) appeals from thirty-four final assessment certificates issued by the Tax Commissioner from Rich’s request for a final assessment and partial refund of personal property assessments for tax years 2000, 2001, and 2002. Rich’s argues that the commissioner erroneously determined the true value of Rich’s retail inventory because the commissioner failed to consider vendor

markdown allowances when determining cost. For the following reasons, we reverse the commissioner's assessment with regard to this issue.<sup>1</sup>

During the period now before us, Rich's was a national chain of retail department stores, which operated in Ohio under the name of "Lazarus."<sup>2</sup> To account for its retail inventory values, Rich's uses what is known as the "Retail Inventory Method" of accounting ("RIM"). RIM is based upon the concept that the cost value of inventory on hand bears the same relationship to retail value as the original cost bore to the original retail value. In other words, the purchase mark-up figured when the inventory is put into stock may be applied to the inventory valued at retail to reduce it to cost. See Emmit, *Department Stores* (Stanford University Press), at 178. RIM "basically consists of taking the retail sales price of the merchandise in stock and deducting therefrom the percentage markup by departments." *R.H. Macy Co., Inc. v. Schneider* (1964), 176 Ohio St. 94, at 97.

At hearing, Rich's presented the testimony of Laurie Velardi, operating vice-president of divisional accounting, who discussed Rich's use of the Retail Inventory Method. According to Ms. Velardi, RIM was developed in the 1920s to assist retailers that stocked large amounts of different items. H.R. Vol. I at 96. Under this method, retailers assign inventory values based on average cost. H.R. Vol. I at 97. At the end of each accounting period, all additions and reductions at retail are considered to arrive at the ending inventory at retail. H.R. Vol. I at 96-98. Applying

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<sup>1</sup> Rich's had listed other specifications of error in its notice of appeal. However, at hearing, Rich's indicated that it is no longer pursuing those other specifications. H.R. Vol. I at 11.

<sup>2</sup> During this period, Rich's was a subsidiary of Federated Department Stores, Inc. Federated changed its name to "Macy's" in August of 2007, and all of its stores now operate under the Macy's name.

RIM, inventory at retail is then reduced by the percentage mark-up to establish the average inventory cost for all items sold in that department. H.R. Vol. I at 96.

Rich's terms its percentage mark-up as "margin performance." H.R. Vol. I at 18, 98. Christy Golden, Rich's director of merchant learning and development, testified that a margin performance is essentially the profit margin that Rich's makes on its merchandise. H.R. at 18. Whenever Rich's purchases merchandise from a vendor, the two agree to a margin performance that is expected for the merchandise over a given period of time. H.R. Vol. I at 19 & 36-39. While the retail price for an item of merchandise is set by market value, H.R. Vol. I at 37, the margin performance is based upon an average amount of expected profit. Thus, when Rich's and a vendor discuss margin performance, there is an understanding that the retail price of the merchandise may undergo some adjustment.<sup>3</sup> H.R. at 38.

Rich's applies two basic types of markdowns to adjust retail price. The first type, known as a point-of-sale ("POS") markdown, is temporary. Rich's generally uses a POS markdown in connection with a promotional event, such as a "one-day sale." H.R. at 38. At the conclusion of the POS event, the price of the merchandise would revert to the higher, pre-sale price. H.R. at 38. The second type of markdown is known as a permanent markdown, or "hardmark." H.R. at 39. When Rich's determines that an item can no longer be sold at its then current price, i.e., its rate of sale slows, Rich's takes a series of permanent markdowns. H.R. at 39. Hardmarks are

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<sup>3</sup> Ms. Golden stressed, however, that only margin performance is discussed with vendors, never price. Ms. Golden testified that buyers are prohibited from discussing retail prices with a vendor. H.R. Vol. I at 41.

essentially a recognition that the merchandise is underperforming. H.R. Vol. I at 23, 39, and 45.

While some hardmarks are anticipated, the sale rate of the merchandise may be slower than expected. As a result, Rich's may attempt to move the merchandise by applying additional hardmarks. H.R. Vol. I at 26. These additional hardmarks, however, reduce the margin percentage. H.R. Vol. I at 26 & 30. Rich's provides each of its vendors with weekly updates on that vendor's margin performance. H.R. Vol. I at 24. In addition, Rich's buyers stay in communication with vendors during the selling season in order to discuss the performance of the vendor's merchandise. *Id.* When a margin performance drops below the anticipated percentage, Rich's buyers will discuss the situation with the vendor and seek to negotiate a monetary contribution from the vendor. H.R. Vol. I at 98. This contribution is garnered to bring the margin performance back to the original level:

“[Ms. Golden] So what would happen is, you know – so if it were that tan jacket that wasn't selling as well, so we would have had prior conversations with [the vendor] about the performance \*\*\* and when it gets to the point we have exhausted really other ways of trying to sell it better and we realize it really isn't the item, it's not going to sell, then what happens with the vendor is we talk to them about, you know, 'Here is where your sales were on the item. Here is where your inventory was. This is what the expected sell through was on the merchandise. We have a lot more inventory than what we had expected to have right now because it's not selling, and , you know, and I had to take \$50,000 in markdowns and \*\*\* I only planned \$40,000 on this item, you know, can you contribute \$10,000 to this merchandise?’” H.R. Vol. I at 30.

According to Ms. Golden, vendors have as much interest in Rich's business success as the retailer does, because Rich's is a place where the vendor's merchandise can be showcased. To maintain a good business relationship, the vendor will frequently make the contribution. H.R. Vol. I at 27.

The contribution is known as a "vendor markdown allowance ("MDA"). However, the MDA is not actually a cash amount paid to Rich's. When Rich's obtains an MDA, it issues a debit memo against the accounts payable due to the vendor, which effectively both reduces the amount Rich's owes to its vendor and lowers its cost of goods sold, thereby increasing margin performance. H.R. Vol. I at 33. MDAs are credited to amounts owed on merchandise subsequently ordered from the vendor, not on the actual merchandise at issue.

Beverly Peralta, operating vice-president of accounts payable, testified that once a vendor authorizes an MDA, the amount is entered into Rich's computer system by the buyer. H.R. Vol. I at 70. The MDA passes through the accounts payable system, and the system searches for financial coverage. In other words, the system verifies that Rich's owes enough to the vendor in order to deduct the amount of the MDA. H.R. Vol. I at 70-71. Once the MDA posts, the accounts payable to that vendor is reduced by the MDA amount. H.R. Vol. I at 72.

Ms. Velardi testified that Rich's systems process MDAs into its stock ledger, where margin performance is calculated using RIM on a departmental level. H.R. Vol. I at 105. MDAs show up as a credit to retail inventory, a corresponding credit to cost inventory, and decrease to markdowns. H.R. Vol. I at 106. This

ultimately results in a reduction of the costs of goods sold, and an increase in margin performance, and is recorded on Rich's profit and loss statement as a debit on Rich's cost of goods liability. H.R. Vol. I at 157.

In the matter before us, Rich's argues that MDAs should be recognized as a reduction in its cost of goods, thereby reducing the taxable value of its inventory. The commissioner counters that MDAs are in the nature of a contribution to margin – an increase in Rich's profit rather than a reduction in the costs of goods.

In support, the commissioner presented the testimony of Dr. Ray Stephens, a former Senior Academic Fellow of the Office of Chief Accountant, Securities and Exchange Commission, and currently the director of the School of Accountancy at Ohio University. Dr. Stephens is also a former faculty member of the Lazarus Management Institute, which is an executive development program for managers. H.R. Vol. II at 8. Dr. Stephens testified as to general accounting principles that apply to inventory. Dr. Stephens testified that, under Accounting Research Bulletin 43 of the Financial Accounting Standards Board ("FASB"), inventory valuation is based upon fair value, which is defined as either market value or replacement cost, whichever is lower. H.R. Vol. II at 9-10. He further testified that, under RIM, inventory value is an amount that maintains the gross profit percentage. "Because it maintains the gross profit percentage that was originally intended \*\*\* it maintains the anticipated markup in our normal profit that is embedded in the markup from the original cost to the selling price, that as you take markdowns, that you apply that percentage, which means you maintain the normal gross profit percentage." H.R.

Vol. II at 17-18. Based upon this standard, Dr. Stephens opined that any vendor allowances would be applied as a reduction in the overall markdowns applied to the price of the merchandise, not as a reduction in the inventory value. H.R. Vol. II at 21.

We now turn to our review of Rich's specification of error. In doing so, we observe that the findings of the Tax Commissioner are presumptively valid. *Alcan Aluminum Corp. v. Limbach* (1989), 42 Ohio St.3d 121. Consequently, it is incumbent upon a taxpayer challenging a determination of the commissioner to rebut the presumption and to establish a clear right to the requested relief. *Belgrade Gardens v. Kosydar* (1974), 38 Ohio St.2d 135; *Midwest Transfer Co. v. Porterfield* (1968), 13 Ohio St.2d 138. In this regard, the taxpayer is assigned the burden of showing in what manner and to what extent the commissioner's determination is in error. *Federated Dept. Stores, Inc. v. Lindley* (1983), 5 Ohio St.3d 213.

Every taxpayer that engages in business within the state of Ohio must annually file a personal property tax return with the county auditor of each county where property used in the business is located. R.C. 5711.02. Under R.C. 5711.101, a fiscal year taxpayer must report taxable property "as of the close of business at the end of his fiscal year." R.C. 5711.15 provides the method for listing and valuing tangible personal property held in inventory:

"A merchant in estimating the value of the personal property held for sale in the course of his business shall take as the criterion the average value of such property, as provided in this section of the Revised Code, which he has had in his possession or under his control during the year ending on the day such property is listed for taxation, or the part of such year during which he was engaged in business. Such average shall be ascertained by taking the

amount in value on hand, as nearly as possible, in each month of such year, in which he has been engaged in business, adding together such amounts, and dividing the aggregate amount by the number of months that he has been in business during such year.”

Upon review of the parties’ briefs, we determine that there are three issues we must consider in the course of this appeal: 1) Do MDAs reduce Rich’s cost, and therefore the true value of its inventory, or do MDAs reduce the amount of hardmarks applied to retail? 2) Does Ohio Adm. Code 5703-3-17 prohibit the treatment of MDAs as a reduction to a retailer’s book value? 3) Has Rich’s met its burden of establishing true value?

As to the first issue, we find that MDAs are indeed a reduction in inventory cost that should be recognized for personal property tax purposes. A review of all of the testimony before this board evidences that MDAs are a common feature in the retail business and are treated by retailers as a reduction in the cost of goods. Cost, for purposes of personal property tax, is not actual cost but inventory value. *Higbee Co. v. Evatt* (1942), 140 Ohio St. 325, at 329.<sup>4</sup> The method has the advantage of automatically recognizing a decline in inventory value due to the impaired value of the merchandise. The application of MDAs as a reduction in cost is also supported by FASB, which oversees the development of accounting practices: “[C]ash

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<sup>4</sup> We note that this case was provided to the board through a “Supplemental Brief of Appellee.” Rich’s has objected to the commissioner’s request that we take notice of this case, on the grounds that it was filed after the briefing schedule and is not a statement of additional authority determined after the briefing. We grant the commissioner’s request to file this citation for our review.

consideration<sup>5</sup> received by a customer from a vendor is presumed to be a reduction of the prices of the vendor's products or service and should, therefore, be characterized as a reduction of cost of sales when recognized in the customer's income statement." EITF<sup>6</sup> Abstract No. 02-16, at ¶4. Ohio case law has further recognized that markdowns are evidence bearing upon the question of inventory value. *Higbee*, supra.<sup>7</sup> See, also, *R.H. Macy & Co. v. Bowers* (June 24, 1963), BTA No. 49960, affirmed, supra.

Nor do we find Dr. Stephens' testimony to be supportive of the commissioner's position. We concur with Dr. Stephens that, under the "conventional" retail inventory method, markups, but not markdowns, are considered when determining a cost-to-retail ratio. See Kieso & Weygandt, *Intermediate Accounting* (7<sup>th</sup> Ed.) at 451. However, in the matter now before us, the cost ratio, i.e., the margin percentage, is known. The question is not how we arrive at the margin but what adjustments must be made to the underlying factors (retail pricing and cost) to maintain the intended margin. Moreover, Rich's treatment of MDAs conforms to the "lower of cost or market" standard for the cost of inventory testified to by Dr. Stephens. He testified that, under RIM, "the inventory value on the financial statements is an amount that maintains the gross profit percentage," which relates to

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<sup>5</sup> "Cash consideration" is defined as including both cash payments and credits that the vendor's customer can apply against amounts owed to the vendor. EITF Abstract No. 02-16, at Ex. 02-16B.

<sup>6</sup> "EITF" refers to FASB's Emerging Issues Task Force. The EITF is an organization formed by FASB in 1984 to provide assistance with timely financial reporting. The primary purpose of the task force is to identify emerging issues and resolve them with a uniform set of practices before divergent methods arise and become widespread. See [http://www.fasb.org/eitf/about\\_eitf.shtml](http://www.fasb.org/eitf/about_eitf.shtml)

<sup>7</sup> The court stressed in *Higbee* that the BTA is not absolutely bound by this evidence but must determine value within the exercise of its discretion. Moreover, the court found in *Higbee*, supra, that the taxpayer could not rely upon evidence of markdowns because it had failed to challenge the application of an administrative formula applied to deductions in inventory value; thus, that appellant was bound to the value arrived at under the formula. *Id.* at 330.

the lower of cost or market. H.R. Vol. II at 13. In short, we find nothing in Dr. Stephens' testimony to refute the evidence presented by Rich's.

Next, the commissioner argues that Ohio Adm. Code 5703-3-17 prohibits Rich's from applying MDAs to reduce its inventory values. The commissioner is to administer the personal property tax laws, adopting any necessary rules "so that all taxable property shall be listed and assessed for taxation." R.C. 5711.09. Accordingly, for inventory purposes, the commissioner has promulgated Ohio Adm. Code 5703-3-16 and 5703-3-17. Ohio Adm. Code 5703-3-16 provides that the value of any inventory required to be listed on the average basis shall be determined as provided by R.C. 5711.15 and 5711.16. Ohio Adm. Code 5703-3-17 provides:

"The true 'average inventory value of merchandise' to be estimated for taxation shall prima facie be the 'average inventory value' at cost as disclosed by the books of the taxpayer, after making proper adjustments for cash discounts and merchandise shrinkage, less the aggregate net markdowns, at cost, (taking into consideration markdown cancellations and additional mark-ups at cost) which are reflected on the books of the taxpayer for the succeeding three months following the close of the annual accounting period of the current tax year.

"Any taxpayer using the 'retail inventory method of accounting', who has cause to file a true value claim with his Personal Property Tax return as authorized by Revised Code 5711.18, should request an extension of time for filing as provided by Revised Code 5711.04, in order that such claim and return when filed will be in conformity with the foregoing."

The commissioner maintains that, under Ohio Adm. Code 5703-3-17, reductions to the book value of inventory, as determined using RIM, may be allowed only for “cash discounts,” merchandise shrinkage,” and “aggregate net markdowns,” reflected on the taxpayer’s books for the last three months of the annual accounting period of the current tax year. The commissioner argues that MDAs are “clearly not ‘merchandise shrinkage,’ nor are they ‘net markdowns’ occurring during the three months after the close of the applicable taxable year.” Appellee’s Amended Brief at 19. Relying upon Dr. Stephens’ testimony, the commissioner further asserts that MDAs are not “cash discounts.” Dr. Stephens testified that the term “cash discounts” would not apply to MDAs because “the cash discounts that would be applied to the cost of the inventory that’s still on hand would not include the inventory that had already been sold.” H.R. Vol. II at 23.

Our reading of the rule does not support the commissioner’s proposed interpretation. Under the plain terms of the rule, the average inventory value is to be based on the average inventory value “at cost as disclosed by the books of the taxpayer.” Once cost is determined on the books of the taxpayer, the rule permits additional adjustments for cash discounts, merchandise shrinkage and net markdowns. These adjustments are made only after the cost of the inventory is determined. As we have previously discussed, cost, as disclosed on Rich’s books, includes MDAs. This reading is consistent with Dr. Stephens’ testimony. He stated that the three adjustments referred to in Ohio Adm. Code 5703-3-17 are for adjustments from book

value. H.R. Vol. II at 26. Here, we are not concerned with a reduction from book value but with those factors that comprise book value.

Rich's has provided us with competent and probative evidence of how it arrived at its book value. Ms. Velardi testified as to how the MDAs pass through Rich's accounts payable and price change systems. These systems track both the price and cost of Rich's merchandise. H.R. Vol. I at 102. Ms. Velardi further testified about how the MDAs flow through Rich's stock ledger and general ledger. The ledger accounts translate Rich's internal data into RIM data at a divisional level. H.R. Vol. I at 105. The ledger accounts are shown on Rich's cost of goods sold, which, in turn, is reflected on Rich's profit and loss statements as a reduction in the cost of goods sold. Rich's also provided copies of various statistical accounts that it uses to track purchases at retail, MDAs, accounts payable, and the accumulation of its data for its general ledger. See, e.g., Appellant's Exs. 4, 5, 6 and 7. All of this information is pertinent to determining the book value of Rich's merchandise.

Moreover, the rule applies to adjustments made during the first three months of the year *following* the close of the current tax year. Our understanding of the rule is that, if a retailer has inventory in place at the close of the current tax year, and if that retailer recognizes an adjustment in the first three months following the end of the tax year, the retailer may nevertheless apply the adjustment back to that tax year being reported. This is recognition that the utility of an inventory item may be impaired at the end of the current tax year; however, any adjustment for that impairment may not show up on the retailer's books until after the close of that year.

Finally, the commissioner argues that we must reject Rich's specification of error because Rich's evidence relies upon estimates of the actual MDAs rather than upon actual MDAs from each store. In support, the commissioner relies upon *United Tel. Co. of Ohio v. Tracy* (1999), 84 Ohio St.3d 506 and *MCI Metro Access Transm. Servs., LLC, et al., v. Wilkins* (Apr. 13, 2007), BTA Nos. 2004-K-749, 750, unreported, affirmed 2008-Ohio-5057. *United Tel.* concerned the valuation of fiber contained in telephone cables that were either reserved for future use or were no longer useable. These were referred to as "dead and bad pairs." The taxpayer did not maintain a record of its dead and bad pairs. So, in order to calculate a value for these pairs, the taxpayer submitted a statistical estimate of the number of dead and bad pairs in its network based upon a random sampling. Noting that the taxpayer had records in its possession upon which it could reconstruct the actual number of dead and bad pairs at issue, the court rejected the statistical estimate. The court stated, "The goal in tax valuation cases is to achieve as much accuracy as possible. The burden of proving the amount of the dead and bad pairs and their value was imposed on United Telephone." *Id.* at 511. This duty was imposed upon the taxpayer despite the magnitude of the effort it would require. The court reasoned that the taxpayer has "assumed this burden when it appealed the commissioner's order." *Id.* at 512.

In *MCI Metro Access*, *supra*, the taxpayer challenged the commissioner's finding of value under the 302 computation. The taxpayer provided this board no evidence of value. Instead it asked that its property simply be reduced on a pro rata basis consistent with the impairment write-down taken by its parent corporation

following the parent's emergence from bankruptcy. We declined to accept the argument, noting that the taxpayer failed to present evidence that was sufficiently probative to show that the value of its personal property was impaired to the same degree as that of the parent company. *Id.* at 14. On appeal, the Franklin County Court of Appeals concurred, noting in its affirmance that "the record did not require the tax commissioner or BTA to conclude, based upon appellant's proposed methodology, that the Ohio taxable property at issue mirrored the various assets comprising MCI/WorldCom's world-wide property, or that appellants' Ohio property suffered the same percentage of impairment as the parent company." *MCI Metro Access*, 2008-Ohio-5057, at ¶25.

We do not find these cases to be relevant to the issue now before us. *United Tel.*, *supra*, concerned the valuation of distinct property, i.e., the actual numbers of dead and bad pairs. The appeal now before us does not concern the valuation of each specific item of inventory. Instead, the cost of inventory that is reported is an average based upon the average cost-to-retail ratio. This is the very nature of RIM accounting, and the method of accounting expressly adopted by statute. R.C. 5711.15. Moreover, unlike the situation in *United Tel.*, Rich's does not rely upon a random sampling of MDAs. Its values are based upon the MDAs actually applied and the cost shown on its books.

With regard to *MCI Access*, *supra*, we reiterate that the valuation under consideration is based upon RIM. This is not an attempt to apply an across-the-board reduction where there are discrete items of property that are to be valued. Here, Rich's

provided through numerous witnesses and documents evidence indicating the amount of MDAs applied, how the MDAs are tracked through its accounts payable system, how the MDAs are applied to reduce cost, how that reduction in cost is shown on its profit and loss statements, and how margin is tracked on Rich's ledgers. Various documents have been submitted showing both the MDA information and its impact on cost. Additionally, the inter-county returns are included in the statutory transcript. The totality of this evidence is sufficiently probative to support Rich's specification that the commissioner erred in not granting Rich's claim for a reduction in inventory value of 6.739% in tax year 2000, 8.536% in tax year 2001, and 10.187% in tax year 2002.

In conclusion, we find that Rich's specification of error is well taken. We therefore determine that the Tax Commissioner's failure to consider Rich's vendor markdown allowances was unreasonable and unlawful. Consistent with this decision, the Board of Tax Appeals orders the Tax Commissioner to grant the requested claim for a reduction in Rich's 2000, 2001, and 2002 inventory value.

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