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## **I. STATEMENT OF CASE AND FACTS**

### **A. Procedural Posture**

The Tax Commissioner takes this appeal as of right pursuant to R.C. 5717.04 from a decision and order of the BTA. This is a personal property tax valuation case involving the merchandising inventories of the appellee, Rich's Department Stores, Inc. ("RDS"), for the 2000, 2001 and 2002 tax years. In reversing the Commissioner's final assessment certificates for those tax years, the BTA ordered the Commissioner to reduce his assessed valuations for each of over 20 taxing districts in 11 counties in across-the-board annual percentages, as follows: 6.739% (2000 tax year); 8.536% (2001 tax year); and 10.187% (2002 tax year) for amounts that RDS characterized as "vendor markdown allowances" ("VMDAs").<sup>1</sup>

In denying RDS' claimed valuation reductions for VMDAs, the Commissioner applied the plain meaning of his Commissioner's administrative rule concerning the valuation of merchandising inventories, Ohio Adm. Code 5703-3-17, initially promulgated in 1948. Thus, in reversing the Commissioner, the BTA departed from six decades of the Commissioner's established administrative practice under which he never has allowed the kind of valuation reductions sought by RDS here.

Indeed, the BTA's reversal is particularly unwarranted under the circumstances. As detailed in the following sections of this Statement of Case and Facts, for the tax years at issue, the Commissioner's assessed "true values" for RDS merchandising inventories were far less than RDS' own "book values" and at the lowest range of reasonableness. Thus, having already granted RDS substantial reductions from its own book values, and having simply applied his

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<sup>1</sup> See the *BTA Decision and Order* at 15, Appx. 15; BTA Ex. 9, Supp. 1233; and the attached table prepared by the Commissioner's Administrator of Personal Property Taxes, John Nolfi, captioned "Summary of RDS' Merchandising Inventory Valuations as Reported, as Amended by the Tax Commissioner, and as Reduced by the BTA." Appx. 62.

own long-standing administrative practice in denying the further reductions sought by RDS, the Commissioner acted reasonably and lawfully.

Moreover, the BTA's decision should be reversed for an independent reason. At the BTA evidentiary hearing, RDS used broad estimates derived from annual national data from its stores system-wide, rather than using RDS' actual VMDA data for each Ohio taxing district/store location and for each month of the taxable years at issue. To show entitlement to relief, this Court requires that actual data for the specific property at issue must be used, not broad estimates derived from its property everywhere. *United Tel. Co. of Ohio v. Tracy* (1999), 84 Ohio St.3d 506, 511-512. Thus, RDS failed to meet its affirmative burden of proof of showing the "extent of any claimed error in the Commissioner's final determination."

For all these reasons, the BTA should have affirmed the Commissioner's valuations as reasonable and lawful.

**B. Like most high-volume retailers, RDS utilizes the "retail inventory method" of accounting to determine the book values of its merchandising inventories.**

The "retail inventory method of accounting" ("RIM") is well suited for high-volume retail businesses with many different types of merchandise. Kiseo, *Intermediate Accounting* (12 Ed. 2007) 436, Appx. 41-42. Under RIM, retailers track inventory items at their expected retail sales prices and then convert those expected retail prices to book values by multiplying the expected retail prices by a "cost to retail sales" ratio. *Id.*<sup>2</sup>

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<sup>2</sup> As explained in further detail in the following Section C of this Statement of Case and Facts, the resulting book value of the inventory under the RIM is its expected retail price less a normal profit percentage. See the BTA testimony of Dr. Ray Stephens, a former senior academic fellow at the Office of Chief Accountant of the Securities and Exchange Commission and current director of the School of Accountancy at Ohio University, BTA Hearing Transcript, Volume II, pages 9 and 13 (Tr. II at 9, 13), Supp. 99-100; BTA Ex. A (Dr. Stevens' curriculum vitae), Supp. 119-81.

RIM provides a fairly quick and reliable measure of the book value of their inventories held for sale. Specifically, because RIM does not require a retailer's individual items of inventory to be tracked by their acquisition costs, retailers gain substantial economies by using RIM. When the retailer conducts physical inventory counts, the inventory personnel need only record each item's retail price (typically marked or bar-coded on the item itself), instead of looking up each item's purchase-invoice cost. Thus, RIM is the industry standard for high-volume, diverse-product retailers. *Id.* 437.<sup>3</sup>

RDS' accounting practices are no exception to the general industry standard; like most other major retailers, RDS uses RIM to determine the book values of its merchandising inventory. *Tr. I* at 95-96, *Supp.* 29; *BTA Decision and Order* at 2. In fact, through filings with the U.S. Securities and Exchange Commission ("SEC"), RDS' parent corporation<sup>4</sup> reports all of its retail subsidiaries' book inventory values using RIM. See, e.g., *BTA Ex. 11, Federated Department Stores, Inc.'s Form 10-K fiscal year ending January 30, 1999 (relating to the 2000 tax year), "Notes to Consolidated Financial Statements"* at F-8, *Supp.* 610.

**C. Under RIM, the book value of merchandising inventory held for sale is determined by reducing the inventory's expected retail price ("net realizable value") by a normal profit margin.**

The basic aspects of RIM remain unchanged from its first widespread use by retailers in the 1920s. *BTA Decision and Order* at 2; *Tr. I* at 96. Accordingly, the description of RIM's

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<sup>3</sup> Because RIM does not track the actual original acquisition costs of individual items of inventory, under RIM, the inventory book values that result from the RIM methodology are, in RIM terminology, the "costs" of the inventory. See, *The Higbee Co. v. Evatt* (1942), 140 Ohio St. 325, 329 and the description of the RIM methodology in Section C of this Statement of Case and Facts, including the detailed description excerpted from a *Higbee* brief.

<sup>4</sup> Presently, RDS' parent corporation is Macy's, Inc.; for the taxable years at issue, RDS' parent corporation was Federated Department Stores, Inc. See *Tr. I* at 94, *Supp.* 29.

basic operation that was provided to this Court in the briefing of a 1942 personal property tax case, *The Higbee Co. v. Evatt* (1942), 140 Ohio St. 325, still holds true today.

Specifically, in that consolidated case, Rollman and Sons Company, one of the three appellant retailers, set forth a detailed description of RIM's basic features at pages 3-5 of its Ohio Supreme Court merit brief. A copy of the full merit brief is reproduced in the Appendix, Appx. 45-61. For the Court's convenience, however, we set forth, in its entirety, the cogent explanation of the basic aspects of RIM (referred to at that time as simply the "retail system" of accounting) from that brief, as follows:

### **THE ACCOUNTING BACKGROUND**

The book value of Rollman's merchandise, or inventory, and its records in respect thereto, are kept under a system, used generally by all of the larger department stores in this state and in the United States, known as the "retail system." (Record, pages 4 and 5.) Under the system, merchandise coming into a store is given a "retail selling price." The difference between the cost of the incoming merchandise and the retail selling price is known as the "mark-up." The mark-up is intended to cover the merchant's cost of doing business and a reasonable profit. Detailed records are kept of the retail selling price, the mark-up, and the relation, in percentage, that the mark-up bears to the retail selling price. Thus, if the store buys \$500,000 worth of merchandise and gives it a retail selling price of \$750,000, it has a record of having on hand an inventory of \$750,000 at "retail," a mark-up of \$250,000, and a "per cent of mark-up" of 33  $\frac{1}{3}$ %, which is to say that the mark-up is 33  $\frac{1}{3}$ % of the retail selling price. Cost of the inventory may then, at any time, be arrived at by deducting the per cent of the mark-up from the retail selling price of the goods.

As new merchandise is purchased, its retail selling price and mark-up are added to the store's records, and a new per cent of mark-up is figured, depending on the relation that the total mark-up bears to the total retail selling price of the entire stock of merchandise. Thus, going back to the example given above, after new merchandise has been added, we may have a stock of goods having a retail selling price of \$875,000, a markup of \$306,250 and a percent of mark-up of 35%. Cost may then arrived by deducting the per cent of mark-up from the retail selling price of the total inventory, and would be in this case \$578,750.

On the other hand, when the retail selling price of an item, or a number of items, of merchandise is reduced, the amount of the reduction, the amount of the reduction described as a "mark-down, (Record, pages 23 and 24) is deducted from the record of the total retail selling price. Thus, to return again to our example, if

a total mark-down of \$25,000 in the retail selling price is made, we will have a retail inventory of \$850,000 and an inventory at **cost** of \$552,500.

From day to day, as sales of merchandise are made, the amount of sales in dollars is deducted from the retail inventory. Likewise, from day to day, new merchandise is received in the store and its retail selling price is added to the store's record of total retail selling price, or retail inventory, and the mark-up on the new merchandise is added to the stores record of mark-up and at the same time the amount of new mark-up is reflected in the per cent of mark-up.

Thus, the cost of inventory may be determined at any time from the records of the store by reducing the retail selling price of the whole inventory by the per cent mark-up. The correctness of these book figures in the case of Rollman was checked at least once a year on January 31, when an actual count was made of each item of merchandise in the store, the total of retail selling price thus obtained being then compared with the total retail selling price on the books of the company and corrections made, if necessary. This actual count of merchandise is termed a "physical inventory." (Record, pages 9 and 10.)

The advantages of the retail system to the merchant are numerous, but the principal advantage is that it affords him a continuing check on the course of his business. The Tax Commission and its agents were thoroughly familiar with this system and all of their calculations with respect to Rollman's inventories, were based on it.

The "average book value" listed in Rollman's tax returns for the years 1936, 1938 and 1939, was obtained by adding together the monthly retail inventories for the preceding year, reducing the total to **actual cost** by deducting the net per cent of mark-up, and dividing that amount by twelve. (Record, pages 13 and 14.)

(Emphasis in original.)

The expert testimony on behalf of the Commissioner of accounting and SEC financial-disclosure expert Dr. Ray Stephens amplifies the foregoing description of RIM. Dr. Stephens' expertise on accounting and SEC disclosure issues is evident from his long, distinguished career in the accounting profession, including as an accounting professor and former SEC official.<sup>5</sup> As

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<sup>5</sup> For a comprehensive review of Dr. Stephens' qualifications and experience, see his curriculum vitae, BTA Ex. A, Supp. 119; and his testimony at the BTA at, e.g., Tr. II, 7-8, Supp. 99; see also, *UBS Fin Servs., Inc. v. Levin*, 119 Ohio St.3d 286, 2008-Ohio-3821, ¶¶22, 28 (finding Dr.

Dr. Stephens' testified at the BTA, under RIM, the book value of merchandising inventory held for sale is determined by reducing the inventory's expected retail price ("net realizable value") by a normal profit margin. See, Dr. Stephens' testimony at, e.g., Tr. II at 13, 17-20, Supp. 100-02; see also, Tr. I at 95-97, Supp. 29; *BTA Decision and Order* at 2, Appx. 8. See, the *Higbee* Court's multiple examples demonstrating the reductions in book value resulting from a retailer's mark down of the retail sales price, 140 Ohio St. at 328-329.

**D. "Vendor markdown allowances" ("VMDAs") differ fundamentally from retailer markdowns. Consequently, by contrast to the reductions in book value that result when a retailer marks down the retail price of its merchandise, RIM book value is not affected by vendor markdown allowances.**

In this case, the BTA granted RDS its sought-for valuation reductions below the "true value" amounts as finally assessed by the Commissioner. RDS predicates its claimed valuation reductions on the assertion that the "true value" of its merchandising inventory should properly include reductions for what RDS calls "vendor markdown allowances" ("VMDAs").

In circumstances when merchandise purchased by RDS from a particular vendor is not selling as well as expected, RDS may "mark down" the retail price of the merchandise. As a result of RDS' reduced profit expectations for that merchandise, the particular vendor may voluntarily reduce RDS' current account balance owed to the vendor, without contractual consideration. The voluntary reductions by the vendor in the "accounts payable" amounts owed to the vendor by RDS are what RDS refers to as VMDAs. In other words, VMDAs are granted by vendors for goodwill purposes to foster and maintain good business relationships. *BTA Decision and Order* at 4-5, Appx. 10-11; Tr. I. at 27-33, 55-56. Supp. 12-19.

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Stephens' expert-witness testimony authoritative in resolution of key accounting issues in a dealer-in-intangibles tax controversy).

For RDS' accounting purposes, these VMDAs have consequences on RDS' balance sheets and RDS' "profit and loss" or "income" statements. These two distinct financial statements serve distinctly different purposes and, therefore, set forth distinctly different financial information. The balance sheet is an asset-valuation financial statement showing snapshots of the assets, liabilities and owner's equity as of the beginning and end of the fiscal year (or other accounting period). By contrast, the profit and loss or income statement is a "statement-of-operations"<sup>6</sup> financial statement showing the profit or loss earned or accrued during the most recent accounting period.

The accounting journal entries that RDS uses to record a VMDA are: (1) to debit (reduce) "accounts payable," and (2) to increase (credit) "receipts," i.e., revenues). Tr. I at 102 (BTA testimony of Laurie Velardi, Vice-President of Division Accounting for Macy's, Inc. and CPA, that "[t]he accounts payable system creates a credit to receipts and a debit to AP [Accounts Payable] liability").<sup>7</sup> In turn, for purposes of RDS' profit and loss statement, because VMDAs are accounted for as "receipts" (revenues), they serve to offset "cost of goods sold, which is a

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<sup>6</sup>In fact, in RDS' parent corporation's Form 10-K filings, the profit and loss statement is captioned as the "Statement of Operations," see, e.g., BTA Ex. 12, F-4, Supp. 433

<sup>7</sup> In its decision below, the BTA made a fundamental mistake in its reading of Ms. Velardi's testimony. Namely, citing to Ms. Velardi's testimony at page 106 of Volume I of the BTA hearing transcript, the BTA states that "MDAs show up [in the stock ledger report] as a credit to retail **inventory**, a corresponding credit to cost **inventory**, and decrease to markdowns." (Emphasis added.) *BTA Decision and Order* at 5, Appx. 5.

In actuality, the text of Ms. Velardi's testimony reads, as follows: "[i]t [the vendor markdown allowance] would show up [in the stock ledger report] as a credit to retail **receipts**, a credit to cost **receipts**, and a decrease in markdowns." Tr. I at 106, Supp. 32. By erroneously substituting the word "inventory" for "receipts," the BTA's decision reflected a fundamental misunderstanding of basic accounting terminology and concepts, which caused it to erroneously conclude that VMDAs reduce inventory cost under RIM, the lynchpin of the BTA's basis for granting RDS' valuation reductions. See *BTA Decision and Order* at 11-12, Appx. 11-12. We discuss these fundamental errors in the Law and Argument section, *infra*.

part of the gross margin presentation set forth on RDS' profit and loss statement. Tr. I at 104-105, Supp. 31.

For balance sheet purposes, VMDAs reduce accounts payable but have no effect on the book values of RDS' merchandising inventory. Tr. I at 102-105, 129, 142, Supp. 31-41; See particularly, the testimony of RDS' witness Ms. Velardi that VMDAs "are not reflected in the cost shown of the balance sheet of the inventories." Tr. I at 129, Supp. 37. Rather, the only impact on the balance sheet is that the VMDA reduces a liability account, i.e., accounts payable, Tr. I at 105, Supp. 37 and, increases "retained earnings" at the end of the accounting period, when the results of the profit and loss statement flow through to the balance sheet, Tr. I at 142, Supp. 41. In other words, as accounted for by RDS, VMDAs do not affect the book values of RDS' merchandising inventories as reported on RDS' balance sheets and general-ledger asset accounts, but VMDAs do increase the profit shown on RDS' profit and loss statements as an offset to RDS' cost of goods sold. Id.

Dr. Stephens confirmed that RDS' treatment of VMDAs as not affecting its merchandising inventory RIM book values is the proper GAAP treatment. He testified that, under GAAP, the VMDAs are "not a change in original cost of the merchandise," and, thus, "would not affect inventory value," Tr. II at 21, Supp. 102, but, instead, should "appear eventually in cost of sales." R. II at 48, Supp. 109.

In sum, under RDS' actual accounting practices, as well as under the accounting treatment required by GAAP for valuing merchandising inventories under RIM, the impact on inventory valuation of VMDAs fundamentally differs from the impact of markdowns of the retail price of merchandise. Unlike a retailer's permanent markdowns of the retail prices of

merchandise, which directly reduce RIM inventory cost (book value) by the “cost to sale” ratio, VMDAs do not affect RIM inventory cost (book value) at all.

**E. In finally assessing RDS’ merchandising inventories, the Commissioner applied the valuation methodology set forth in Ohio Adm. Code 5703-3-17, which establishes a “prima facie” inventory value. Under that methodology, the Commissioner’s inventory valuations for the 2000, 2001 and 2002 tax years were 18.1%, 20.9% and 23.3% below RDS’ own RIM book values, respectively.**

In determining the average “true values” of RDS’ merchandising inventory for the tax years at issue, the Commissioner applied the valuation methodology set forth in Ohio Adm. Code 5703-3-17, which establishes a “prima facie” true value for those retailers who use RIM to determine the book value of their merchandising inventories. Tr. I at 237, Supp. 64; Statutory Transcript of evidence certified by the Commissioner to the BTA, (“S.T.”) at 68-72 (Ohio Department of Taxation Audit Remarks), Supp. 703-07.

Ohio Adm. Code 5703-3-17 is well established, to say the least. It originally was issued effective April 10, 1948, as Commissioner Rule TX-41-16, Appx. 23, and was reissued, with the identical substantive language, as Ohio Adm. Code 5703-3-17 effective November 18, 1957, Appx. 22. For the Court’s convenience, we restate the Rule in its entirety as follows:

**5703-3-17 Average inventory value of merchandise of taxpayer using “retail inventory method of accounting”**

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.

(Emphasis added.)

As the bolded language of the Rule shows, the methodology set forth in the Rule is, by its own terms, only presumptively valid. That is, the inventory valuations that result from application of the methodology establish a “prima facie” “average inventory value.”<sup>8</sup> For purposes of the discussion which follows, the three component steps of this “prima facie” methodology may be identified separately and labeled descriptively.

The first step of the methodology is to ascertain the merchant’s “average inventory value at cost as disclosed by the books of the taxpayer.” That is, the merchant’s own RIM “book values” for its merchandising inventories, as averaged monthly over the taxable year, are the starting point in the methodology. Next, these RIM book values are “adjusted for cash discounts and shrinkage.” Finally, the RIM book values as adjusted for cash discounts and shrinkage, are reduced by “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 for the current tax year.”

This last step entails ascertaining the “aggregate net markdowns” of a merchant’s retail merchandising inventory that the merchant experiences during the first quarter after the close of the current taxable year. The aggregate net markdown amounts that occur during the first quarter of the next taxable year are then “related back” to reduce the merchant’s RIM book values for the previous year, as adjusted for cash discounts and shrinkage. Thus, for purposes

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<sup>8</sup> The phrase “average inventory value” refers to the requirement in R.C. 5711.15 that the true value of merchandising inventory must be determined monthly for each month of the taxable year. The month-end values are then summed and divided by the number of months that the merchant was engaged in business during the taxable year. In other words, merchandising inventory is determined using a “monthly average value.” See, R.C. 5711.03.

of this brief, the reduction provided in this last step of the methodology is referred to as the “next-quarter-markdowns reduction.”

For the tax years at issue, RDS filed its Ohio personal property tax returns on the basis of RDS’ interpretation of the *prima facie* valuation methodology in Ohio Adm. Rule 5703-3-17. RDS’ subsequently filed applications for final assessment also were based on RDS’ interpretation of that methodology. To provide the Court with a quick visual summary of a dense amount of information concerning the quantification of the Commissioner’s and RDS’s valuation computations, the Commissioner has attached a summary table. The table is captioned “Summary of RDS’ Merchandising Inventory Valuations as Reported, as Amended by the Tax Commissioner, and as Reduced by the BTA” (“Summary Table”), Appx. 62. The Commissioner’s personal property tax administrator, John Nolfi, prepared the Summary Table, which shows for each of the three tax years (by separate columns) the key aggregate valuation-claim data in twelve rows.

The Summary Table allows the reader at a glance to see the magnitude of the reductions from RDS’ book values granted by the Commissioner and the further reductions granted by the BTA, as compared with RDS’ RIM book values.<sup>9</sup> Additionally, the Summary Table sets forth the source documentation for each row and column by referencing the relevant page of the Statutory Transcript or BTA exhibit (in half-columns to the immediate right of each tax year’s full column).

As shown from the Summary Table, in filing its Ohio personal property tax returns for the 2001-2001 tax years at issue, in the aggregate (for all taxing districts combined) RDS sought reductions below its book inventory values of 14%, 15.4% and 14.7%, respectively, all

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<sup>9</sup> To assist the reader in reviewing the Summary Table, a description of the categories of information is provided in a “Glossary” following the Summary Table, Appx. 63.

attributable to claimed next-quarter-markdowns reductions. Thereafter, on review of RDS' applications for final assessment and following the Commissioner's review of RDS' inventory records concerning the next-quarter markdowns, the Commissioner granted even greater reductions from book value for RDS' next-quarter markdowns than RDS had claimed on its originally filed returns. Specifically, the Commissioner's valuations for the 2000, 2001 and 2002 tax years were 18.1%, 20.9% and 23.3% below RDS' book values, respectively. Finally, pursuant to the BTA's decision, the BTA granted further reductions below the Commissioner's own reductions from book value for the 2000-2002 tax years of 6.7395%, 8.536% and 10.187%, respectively.

**F. The Commissioner followed his own long-standing administrative interpretation of the presumptively valid valuation methodology set forth in Ohio Adm. Code 5703-3-17, in accordance with its plain meaning.**

Under the Commissioner's interpretation of the presumptively valid valuation methodology set forth in Ohio Adm. Code 5703-3-17, reductions for VMDAs are plainly not encompassed within that methodology. In fact, in applying the Rule's methodology, the Commissioner never has recognized the kind of claimed valuation for VMDAs sought by RDS here. Tr.I at 241, Supp. 65 (testimony of Administrator Nolfi). From his over 25 years of personal property tax auditing experience and educational background as an accounting degreed Youngstown State graduate, Mr. Nolfi provided perhaps the best possible source for this long-standing administrative practice. Tr. I at 235-236, Supp. 64.

In the Commissioner's auditing staff's review of RDS' applications for final assessment, they expressly determined that VMDAs are not appropriately considered in the Rule's presumptively valid valuation methodology because VMDAs "are not cash discounts or shrinkage as allowed per OAC Rule 5703-3-17 \*\*\*." Commissioner's Audit Remarks, Tax Form

No. 807C, S.T. 72 (¶16, Conclusions and Reasons), Supp. 707 and his “synopsis” at S.T.62, Supp. 697. In his expert testimony at the BTA, Dr. Stephens likewise established that, as the term is used under GAAP for purposes of financial-statement disclosure, VMDAs are not encompassed within the meaning of “cash discounts.” Tr. II. 22, 23, Supp. 103.

Even more plainly, RDS’ VMDAs are not encompassed within the meaning of the Rule’s phrase “average inventory at cost as disclosed by the books of the taxpayer.” As detailed in Section D of this Statement of Case and Facts, VMDAs were not included by RDS in its computation of its RIM book values. Because RDS is a subsidiary of a publicly held parent corporation, its accounting practices for financial statement disclosure purposes must accord with GAAP. Thus, it hardly should be surprising that, in RDS’ actual inventory valuation practices, VMDAs have no impact on its valuation of merchandising inventories. As Dr. Stephens testified, under GAAP, VMDAs “[do] not affect inventory value.” Tr. II at 21, Supp. 102.

To summarize, the VMDA reductions sought by RDS below its RIM book values fall plainly outside the Rule’s presumptively valid methodology. Thus, in accepting RDS’ erroneous interpretation of that methodology, the BTA’s decision was unreasonable and unlawful. Moreover, the Commissioner’s long-standing administrative practice to deny VMDA reductions is reasonable and lawful for an additional powerful reason: a consideration of the evidence establishes that the Commissioner’s assessed valuations were already at the lowest possible reasonable “true values.”

- G. As Dr. Stephens’ expert accounting testimony established, because RIM book value is determined by reducing the inventory’s expected selling price (“net realizable value”) by a normal profit percentage, a retailer’s RIM book values are the lowest market “fair values” for inventory valuation purposes permissible under GAAP.**

Citing to what he identified as the most authoritative source under GAAP on the subject, Accounting Research Bulletin No. 43, Chapter 4, Statement 6, Dr. Stephens explained that, under GAAP, merchandising inventories are valued under a “lower of cost or market” approach. Tr. II. at 12-13, 16-18, 37, Supp. 100-06. In the phrase “lower of cost or market,” the term “cost” means the original acquisition cost, whereas “market” means replacement cost. Tr. II at 11, Supp. 100. Thus, under RIM, book inventory value never will exceed its original acquisition cost, but may be valued at a “market” valuation below that original acquisition cost. As detailed in Section C, *supra*, this will occur whenever the retailer permanently marks down the retail price of its merchandising inventory.

Dr. Stephens further testified that, as provided in Accounting Research Bulletin No. 43, RIM results in the lowest possible “fair value” for determining merchandising inventory value permissible under GAAP. See, e.g., Tr. II at 9, 16-17, 25-27, Supp. 99-104. Specifically, under Chapter 4, Statement No. 6 of ARB No. 43, the “higher bound” of permissible inventory market “fair values” is the expected retail price, i.e., “net realizable value,” and the “lower bound” is RIM, i.e., net realizable value minus a normal profit margin. *Id.*

Dr. Stephens then proceeded to define “fair value” for GAAP purposes as the amount a willing buyer and a willing seller would agree to pay for the asset with neither the seller nor the buyer under a compulsion to engage in the transaction. Tr. II 10-12, Supp. 100. Furthermore, he testified that the GAAP definition of market “fair value” is synonymous with “true value” as defined by this Court’s case law, including *Shiloh Automotive, Inc. v. Levin*, 117 Ohio St. 3d 4, 2008-Ohio-68.

**H. Even without considering the Commissioner's long-standing administrative practice to deny reductions to RIM book value for VMDAs, the Commissioner reasonably denied RDS' claims because the assessed valuations were already 20% below RDS' book values and far lower than the lowest acceptable market "fair value" under GAAP, a term synonymous with this Court's definition of "true value."**

The valuation reductions sought by RDS regarding its VMDA claims for the 2000, 2001 and 2002 tax years are in amounts that would reduce the Commissioner's assessed valuations by 6.7395%, 8.536% and 10.187%, respectively. See Section D, *supra*, and the Summary Table, Appx. 62. The Commissioner's assessed valuations for the 2000-2002 tax years were 18.1%, 20.9% and 23.3% below RDS' RIM book values. *Id.* Thus, by any reasonable measure of "true value," the inventory valuations assessed by the Commissioner already were quite generous to RDS, so that any further reductions clearly would be unwarranted. At the BTA evidentiary hearing, both Dr. Stephens and the Commissioner's personal property tax administrator, John Nolfi, so testified.

Dr. Stephens stated that the next-quarter-markdowns reductions the Commissioner applied to determine RDS' inventory valuations for Ohio tax purposes are valuation reductions that are not permitted under GAAP. Specifically, these reductions would reduce the inventory valuations to amounts well below RIM book value (by approximately 20%), and RIM book value is the lowest acceptable market "fair values" under GAAP. Tr. II at 25-27, 41-42, Supp. 103-04. Further, as defined under GAAP, market "fair value" is synonymous with "true value" (see Section I, *supra*). It necessarily follows, therefore, that, if an inventory valuation is lower than the lowest market "fair value" permitted under GAAP, it must, at least to the same degree, be too low for purposes of determining "true value" for Ohio personal property tax purposes. *Id.*

Administrator Nolfi's testimony was to the same effect, applying this Court's definition of true value. Mr. Nolfi noted that the best evidence of true value is a recent arm's-length sale

between a willing buyer and willing seller. Tr. I 215, 239-250, Supp. 59-68. He then explained that the transactions between RDS, as a merchandise purchaser, and its vendors, as sellers of the merchandise, would normally constitute such “arm’s-length” transactions. Under these circumstances, valuing RDS’ inventory at its recent acquisition cost accords with true value. Thus, RIM book value, which results in lower valuations than acquisition cost, already is at a low true value. Consequently, valuations 20% lower than RIM book value, as were assessed by the Commissioner here, are “quite generous” and “well below cost.” Tr. I at 238, 245, Supp. 65-66.

- I. **To compute each of its Ohio stores vendor markdown allowances, in lieu of the store’s actual VMDA experience, RDS used a broad estimate that assumed that each RDS’ store location throughout the United States, whether in Ohio or outside Ohio, received the exact same proportionate amount of VMDAs relative to that store’s merchandising inventory purchases.**

At the BTA hearing, RDS based its claimed reductions for VMDAs purely on estimates drawn from its retail store operations throughout the United States. The methodology used by RDS is a simple percentage calculation, which is set forth on RDS’ one-page BTA Ex. 9, sub-captioned “Vendor Allowance Exclusion Calculation,” Supp. 1233.

Namely, for each of the three tax years at issue, RDS computed a broad annual percentage estimate pursuant to which RDS’ total annual VMDAs for all of its stores throughout the United States are divided by its total merchandising inventory purchases for all of its stores throughout the United States. Mathematically, the percentage calculation is as follows: Total annual VMDAs / Total annual merchandise purchases. BTA Ex. 9, T. I. at 164-169. The annual percentages for the 2000, 2001 and 2002 tax years are 6.7395%, 8.536% and 10.187%, respectively.

The evidence establishes that the VMDA amounts and inventory purchase amounts used to compute these annual percentages were totaled from all of RDS' store locations throughout the United States. See Tr. I at 164-166, 175-176, Supp. 46-49. For the taxable years at issue, most of the RDS store locations were outside of Ohio. See the list of store locations provided to the Commissioner's auditing personnel by RDS' then-tax representative, Randy Ochs, showing that during 1999 RDS had 128 store locations of which only 28 were Ohio stores. S.T. 133-135, Supp. 768-70; see also, Darlene Siciliano's testimony concerning this list of RDS store locations. Tr. I at 180, Supp. 50.

To arrive at the VMDA reductions for its Ohio stores, RDS then asks the annual percentages set forth in BTA Exhibit 9 be applied across-the-board to each store location for each month of the taxable year. For example, for the 2000 tax year, each Ohio taxing district would be entitled to a reduction of 6.7395% from the Commissioner's assessed monthly average "true value."

In other words, no matter what a particular store's actual VMDA experience for each of the twelve months of the measuring year happened to be, RDS' estimate unreasonably assumes that each store received VMDAs in the exact amount of 6.7395% of the Commissioner's assessed monthly average true value for that store. Whether the store was located in a rural or urban area, whether in a Southern climate or a Northern one, RDS' percentage estimate assumes that each store's VMDA experiences would be identical, relative to the store's merchandising purchases, despite differences in merchandise, vendors, retail customers, local economic conditions and buying patterns. RDS offered no evidence to even to attempt to establish the reasonableness of such assumptions.

Any further facts will be referenced directly to the evidentiary record in the Law and Argument Section which follows.

## **II. LAW AND ARGUMENT**

### **Proposition of Law No. 1:**

**The Tax Commissioner acts reasonably and lawfully in denying a retail merchant's sought-for valuation reductions below the Commissioner's assessed average merchandising inventory valuations when:**

- (1) The retailer predicates its claimed reductions on an interpretation of the Commissioner's retail-inventory-valuation rule, Ohio Adm. Code 5703-3-17, contrary to the Commissioner's own long-standing interpretation of that rule;**
  - (2) The Commissioner interprets the presumptively valid inventory-valuation methodology set forth in the rule consistent with its plain meaning;**
  - (3) At the retailer's urging, the BTA erroneously applies a key phrase of the rule incorrectly;**
  - (4) The retailer's claimed reductions are not permitted under generally accepted accounting principles (GAAP) in valuing merchandising inventory and were not made by the retailer in valuing its inventory for financial statement disclosure purposes; and**
  - (5) The Commissioner's valuations, even without the claimed reductions, are approximately 20% below the retailer's book valuations computed under the "retail inventory method," a method that results in valuations at the lowest range of market "fair value" as defined under GAAP, a term synonymous with Ohio "true value."**
- A. The Commissioner's long-standing interpretation of his own administrative rule is entitled to the maximum deference.**

At issue is the reasonableness and lawfulness of the Commissioner's long-standing administrative practice in valuing retail merchandising inventory for personal property tax purposes, under which the Commissioner never has allowed the kind of reductions in true value that the BTA granted to RDS here for its vendor markdown allowances ("VMDAs"). The

Commissioner presented the best possible source to establish the long-standing nature of his administrative practice. At the BTA, John Nolfi, the Commissioner's personal property tax administrator, testified on the basis of his over twenty-five years of personal property tax auditing experience with the Ohio Department of Taxation.

This Court's precedent gives great deference to an administrative agency's well-established administrative practice, particularly where, as here, the "agency has accumulated substantial expertise," and the General Assembly "has delegated to the agency responsibility for implementing the legislative command." *State ex rel. McLean v. Indus. Comm.* (1986), 25 Ohio St.3d 90, 92; Accord, *UBS Fin Servs., Inc. v. Levin*, 119 Ohio St.3d 286, 2008-Ohio-3821, ¶34 ("long standing administration practice[ ] \*\*\* should not be set aside unless judicial construction makes it imperative to do so") (quoting *In re Packard's Estate* (1963), 174 Ohio St. 349, 356).

Further apropos to the circumstances of this case, the deference accorded to long-standing administrative practice is heightened to a maximum level when the challenge to the practice is predicated on the assertion that the agency has misinterpreted its own rules or regulations. *Charvat v. Dispatch Consumer Servs.*, 95 Ohio St.3d 505, 2002-Ohio-2838, ¶37 (provided that it does not violate the Constitution or a statute, an agency's interpretation of its own regulation "**must be given 'controlling weight** unless it is plainly erroneous or inconsistent with the regulation") (quoting *Stinson v. United States* (1993), 508 U.S. 36, 44-45) (emphasis added).

As a result, an agency's interpretation "regarding its own rules is due **even greater** deference than the agency's \*\*\* [interpretation of a statute] \*\*\* in *Chevron* [*Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.* (1984), 467 U.S. 837]. (Emphasis added.) *Chavat*, at ¶35 (citing *Stinson*, 467 U.S. at 44-45).

That is precisely the nature of the challenge to the Commissioner's administrative practice advanced by RDS in this case. Not only is the Commissioner's challenged administrative practice a long-standing and uniform one, it finds expression in his duly promulgated administrative rule on valuing retail merchandising inventory, Ohio Adm. Code Rule 5703-3-17. That Rule provides for the valuation of inventory by taxpayers that employ the "retail inventory method of accounting" (or "RIM") for book purposes, a broad class of retailers that includes RDS. As Administrator Nolfi and the auditing agent testified at the BTA, in denying the valuation reductions sought by RDS, the Commissioner applied the plain meaning of the RIM Rule.

Promulgated in 1948, the RIM rule has stood the test of time. Today, as throughout its history, the rule is substantively identical to its original language. From its original issuance by the Commissioner over six decades ago, the rule has guided the Commissioner and retail merchants alike in the determination of retail merchandising inventory value. Until now, the Commissioner's interpretation of the RIM rule had been met with virtually universal acceptance by Ohio retail merchants. In fact, to the Commissioner's knowledge, no retailer ever has successfully challenged the Commissioner's application of the RIM rule at the BTA, until this case.

Thus, in determining the merits of the parties' competing interpretations of the Commissioner's RIM rule, the BTA should have given due deference to the Commissioner's own long-standing, generally accepted interpretation. Specifically, under this Court's precedent, the BTA should have held the Commissioner's interpretation to be "controlling," unless the BTA determined the Commissioner's interpretation was "plainly erroneous or inconsistent with" the Rule. *Charvat*, supra. The BTA, however, did nothing of the sort. Instead, the BTA quietly

replaced the Commissioner's interpretation of the RIM rule with its own, without so much as a whispered acknowledgement of the proper deference that the BTA should have accorded to the Commissioner's interpretation.

But the BTA's failure to recognize and apply due deference to the Commissioner's administrative practice, as anchored in the plain meaning of the Commissioner's administrative rule, is not its only reversible error; the reasonableness and lawfulness of the Commissioner's rejection of RDS' claimed valuation reductions easily withstand RDS' attack even without considerations of the deference owed the Commissioner.

**B. The Commissioner's interpretation of the presumptively valid inventory-valuation methodology set forth in Ohio Adm. Code 5703-3-17 applies its plain meaning; by contrast, the BTA's and RDS' interpretation/application conflicts with GAAP and with RDS' own inventory valuation practices for financial statement disclosure purposes.**

In two fundamental respects, the BTA's interpretation/application of the RIM rule contravenes the plain meaning of the rule and, ultimately, the General Assembly's directive to the Commissioner to reasonably and lawfully determine the "true value" of Ohio taxpayers' taxable personal property. First, at the invitation of RDS, the BTA misinterprets and misapplies the presumptively valid methodology for determining the true value set forth in the Rule. The BTA's application/interpretation of a key phrase of the rule's methodology was plainly erroneous.

Specifically, as we detailed in Section D of the Statement of Case and Facts, the BTA erred in concluding that the valuation reductions sought by RDS for what it calls "vendor markdown allowances" (VMDAs) were "cost" reductions used by RDS to reduce the RIM book values of its merchandising inventory. To reach this erroneous conclusion, among other things, the BTA had to misunderstand or ignore the testimony of RDS' own witnesses, including the

testimony of Laurie Velardi, Macy's, Inc.'s Vice-President of Division Accounting for Macy's, Inc. and CPA.

As detailed in fn. 9 of this brief, T.C. Br. 10, *supra*, to reach its mistaken conclusion, the BTA's decision ignores Ms. Velardi's testimony that VMDAs do not have any impact on RDS' RIM inventory valuations as set forth on its balance sheets and other inventory valuation account records. Instead, the BTA relies on a single sentence of Ms. Velardi's testimony, which the BTA then completely changes the meaning of the sentence by replacing the word "receipts" with the word "inventories."

Similarly, the BTA disregards the testimony of Dr. Ray Stephens, a former senior academic fellow at the Office of Chief Accountant of the Securities and Exchange Commission and current director of the School of Accountancy at Ohio University. As detailed in Section D of the Statement of Case and Facts, Dr. Stephens testified that, under GAAP, VMDAs are not properly deducted to determine RIM book value.

But even more basically, the BTA's erroneous conclusion that VMDAs truly were actually deducted by RDS to determine its RIM inventory valuations for financial statement purposes flies in the face of the inventory valuation information furnished by RDS with its returns and applications for final assessment. As described in Section E, under the presumptively valid methodology set forth in Ohio Adm. Code 5703-3-17, the retailer's RIM book value is the "starting point" of the methodology. Thus, if, as the BTA somehow concluded, RDS' reductions for VMDAs were truly part of its RIM book values, in RDS' submissions to the Commissioner, those reductions would have been characterized by RDS as such all along.

A review of RDS' submissions to the Commissioner, including those referenced in the attached Summary Table, Appx. 62, however, shows that RDS itself never presented its VMDAs

to the Commissioner as reductions that RDS used to determine the book values of its merchandising inventories under the retail inventory method. Instead, RDS separately set forth its claimed reductions for VMDAs and asserted that VMDAs were included in “cost of goods sold,” a profit and loss statement entry, not an asset valuation one.

Thus, if RDS’ VMDAs actually were included in its RIM book values, then it is hard to see why, in its submissions to the Tax Commissioner for the tax years at issue, RDS would have fragmented its RIM book values into two separate categories, one including all of RIM book value except VMDAs, and the other including just the VMDA portion of the RIM book value.

Once the BTA’s misunderstanding of RDS’ actual accounting treatment of VMDAs and the BTA’s misunderstanding of the proper GAAP treatment of VMDAs is corrected, its rationale for reversing the Commissioner disappears. That is, the BTA apparently agrees with the Commissioner and Dr. Stephens that VMDAs are not “cash discounts” under the rule. Thus, if the VMDAs are not reductions to RDS’ book values under RIM (as the evidentiary record plainly demonstrates) then the Commissioner’s assessed valuations correctly applied the presumptively valid methodology set forth in Ohio Adm. Code 5703-3-17.

**C. The methodology set forth in Ohio Adm. Code 5703-3-17, by its own terms, establishes only a rebuttable presumption of value, not a conclusive one.**

Having misinterpreted/misapplied the methodology set forth in the rule contrary to the evidentiary record and GAAP, the BTA drastically compounded that error by refusing to evaluate, or even to acknowledge, the Commissioner’s compelling evidence and analysis in support of his assessed valuations. The Commissioner’s evidentiary presentation and factual and legal analysis demonstrated that the Commissioner valued RDS’ merchandising inventories at the very lowest range of reasonable “true values.” See particularly, Sections G and H of the

Statement of Case and Facts, *supra*. Thus, the substantial further reductions sought by RDS were unreasonable and unlawful. The BTA had a duty to consider that evidence and analysis. By its failure to do so, the BTA effectively elevated the rule's methodology (as re-interpreted/misapplied by the BTA) as conclusively binding on the Commissioner and the BTA.

This second error constituted a particularly egregious departure from this Court's established precedent, as well as a plain misreading of the rule. By its own terms, the rule merely establishes a "prima facie" true value. Thus, the rule itself contemplates that the Commissioner may determine true value by a methodology different from the one set forth therein. Moreover, this Court long has held that the Commissioner should, and must, exercise his professional judgment, expertise and discretion in arriving at true value, rather than mechanically apply a valuation formula. *Higbee Co. v Evatt* (1942), 140 Ohio St. 325, 330-331 ("it was for the Tax Commission [now Tax Commissioner], in the exercise of its discretion, to determine true value.")

In this way, the BTA abdicated its own statutory responsibilities as the tribunal charged with reviewing the Commissioner's valuation findings. By this judicial sleight of hand, the BTA unlawfully sidestepped its statutory responsibility in all appeals of the Commissioner's personal property valuations: to evaluate "the whole evidence." *Higbee*, *supra*. Moreover, in undertaking that task, the BTA then must determine whether the one challenging the Commissioner's valuations has met its affirmative burden of demonstrating those findings to be clearly unreasonable or unlawful. *HealthSouth Corp. v. Levin*, 121 Ohio St.3d 282, 2009-Ohio-584, ¶30; *Shiloh Automotive, Inc. v. Levin*, 117 Ohio St.3d 4, 2008-Ohio-68, ¶16.

Instead, the BTA's decision did the exact opposite: it accorded no weight to the Commissioner's findings and, in fact, completely ignored the evidence and reasoning employed by the Commissioner in determining the true values of RDS' merchandising inventory.

**Proposition of Law No. 2: When, at the BTA, an appellant taxpayer relies exclusively on simplistic estimates based on assumptions that are unsubstantiated and unreasonable on their face, it fails to meet its affirmative burden of factually establishing the extent of the Commissioner's error in denying the taxpayer's claimed reductions.**

Finally, independent from the foregoing reasons for reversal, RDS failed to meet its affirmative burden of proof of showing "the extent of any claimed error in the Tax Commissioner's final determination." *HealthSouth; Shiloh Automotive*, supra. To support its claimed reductions, RDS relied solely on a simplistic, across-the-board percentage calculation based on RDS' stores throughout the United States. As detailed in Section I of the Statement of Case and Facts, supra, RDS used a broad estimate that assumed that each RDS store location throughout the United States, whether in Ohio or outside Ohio, received the exact same proportionate amount of VMAs relative to that store's merchandising inventory purchases.

Whether the store was located in a rural or urban area, whether in a Southern climate or a Northern one, RDS' percentage estimate assumes that the store's VMA experiences would be identical, despite differences in merchandise, vendors, retail customers, local economic conditions and buying patterns. RDS offered no evidence to even attempt to establish the reasonableness of such assumptions.

Instead of its use of a broad estimate based on generalized data to meet its affirmative burden of proving the amount of its claimed valuation reductions, RDS should have presented the BTA with the relevant **actual** data from its Ohio store locations for each taxing district for each month of the taxable years at issue. By using across-the-board estimates in lieu of actual data, RDS failed to meet its affirmative burden of proof. *United Tel. Co. of Ohio v. Tracy* (1999), 84 Ohio St.3d 506, 511-512; *MCI Metro Access Transmission Services, LLC et al. v. Wilkins* (Apr. 13, 2007), 2008-Ohio-5057, Franklin County Ct. of Appeals Nos. 07APH05-0398 and -0399.

In its decision below, the BTA erroneously circumvents this whole analysis by ignoring the RDS exclusion calculation, as set forth in BTA Exhibit 9. Instead, for unexplained reasons, the BTA concluded that the valuation reductions for VMDAs sought by RDS here are based on each Ohio store location's own individual VMDA experience. To be sure, RDS' total annual VMDAs, as set forth in the RDS exclusion calculation, no doubt, includes the Ohio store VMDAs. Likewise, RDS' total annual inventory purchases, as set forth in the exclusion calculation, no doubt, includes those of the Ohio stores, but only in that extremely limited and diluted way does the RDS exclusion calculation utilize any actual Ohio data.

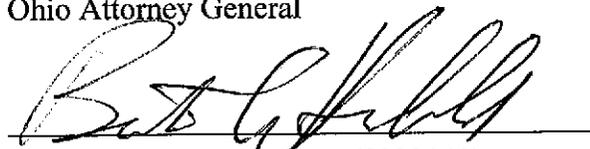
Thus, for this independent reason, RDS' claimed reductions should be denied and the BTA's decision reversed.

### III. CONCLUSION

For all the above reasons, the BTA's reversal of the Commissioner's final determination denying RDS' claimed valuation reductions should be reversed.

Respectfully submitted,

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**CERTIFICATE OF SERVICE**

I hereby certify that a true copy of the foregoing *Brief of Appellant, Tax Commissioner of Ohio* was served upon the following via regular U.S. Mail on this 29th day of June 2009:

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