Taxation of Merchandise Inventory

Merchandise held for resale by a merchant, his inventory, is subject to the personal property tax in Iowa at the same rate of tax as real estate in each taxing jurisdiction. This report discusses the assessment of inventories, other proposals for taxing merchant's personal property and how some other states tax inventories.

IOWA LEGISLATIVE RESEARCH BUREAU
BULLETIN NO. 26
JANUARY, 1961

Foreword

The study of the taxation of merchandise inventories was made at the request of Representatives Aubrey, Baumhover, Edgington, Fairchild and Gray. An advisory committee of legislators was appointed by the Legislative Research Committee to direct and assist the Legislative Research Bureau in the study. This Committee will make a separate report of its findings and recommendations.

Clayton L. Ringgenberg
Director of the Research Bureau

* * * * *

Table of Contents

* * * * *

Advisory Committee

Sen. Duane E. Dewel
Sen. Lynn Potter
Sen. Clifford M. Vance

Repr. John Gray
Repr. R. P. Harrington
Repr. Floyd P. Edgington
Repr. Robert W. Naden

This bulletin is intended to be factual only. Its contents should not be interpreted as recommendations of the Bureau.

HIGHLIGHTS OF THIS BULLETIN:

Rate of Tax on Merchandise Inventories

Merchandise held for resale by a merchant, his inventory, is subject to the personal property tax at the general property tax rates of each taxing district. The county or city assessor, as the case may be, makes the assessment of all inventories in his jurisdiction.

Basis of Assessment

The assessment is made on the average inventory of the merchant during the year. The average inventory is then assessed at 60% of actual value. Actual value is something less than market value as determined by assessors. It is the contention of retailers that the actual value of inventories, as determined by the assessor, is higher than the actual value placed on real estate.

Slow Turnover Businesses

Slow turnover businesses doing a comparable amount of business usually pay taxes on larger inventories than fast turnover businesses. Two factors which may account for this are obsolescence and inflexibility of inventory of slow turnover businesses.

Reduction for Slow Turnover Businesses

Section 66 of Chapter 291, Acts of the Fifty-Eighth General Assembly, granted a reduction of one percent on actual value of merchandise inventories for each number of annual turnovers less than twelve. Businesses with turnovers of more than twelve would have received no reduction. However, an opinion of the Attorney General declared this section of the law null and void due to a technical error in drafting.

Other Proposals Introduced for the Taxation of Inventories

A proposal introduced in the 1955 session of the legislature, House File 41, would have lowered assessments on inventories of slow turnover businesses. This proposal would have applied to retail inventories, but not wholesale or manufacturing inventories.

A proposal in 1953 would have given the taxpayer the option of the personal property tax or a ½ of 1% in-lieu tax based on net sales of retail and wholesale establishments.

Another proposal, in 1959, would have levied a mandatory rate of ½ of 1% on all retail sales subject to sales tax in lieu of the personal property tax on inventories. This would not have applied to wholesale sales.

1-12-66 Ia. Legislative Research Bureau gift

Other Possible Replacements for the Inventory Tax

A percentage of gross receipts is used as the base for the "Turnover Tax" in St. John, New Brunswick. The percentage of gross receipts varies among the types of businesses, and the average rate of markup is the main factor used in determining the different assessment percentages. The rate of tax is the current property tax rate.

A proposal for a gross profits tax was considered by the National Tax Association a few years ago. No state has adopted such a tax. All merchants engaged in the business of selling merchandise within the taxing jurisdiction would be subject to a "merchants' license tax" based on the gross merchandise profit realized from the sale of their merchandise. The rate applied to the gross profit would depend on the revenue needed. However, Joseph Martel, who proposed the tax, estimated that the rate would probably be from 1 to 2%.

Taxation of Inventories in Other States

Some states tax the average inventory of merchants and others tax the inventory on a specific date, such as January 1. There are advantages and disadvantages to both ways. It appears that many states have much the same problems in the assessment and taxation of inventories as does Iowa.

Conclusion

Inventories are assessed at a higher percentage of market value than real estate. The law does not provide assessors with the proper means to obtain information when withheld by taxpayers. The provision in Iowa law for actual value leaves the determination of such value to every assessor because actual value is not defined. There are inequities of assessment between inventories and real estate and between inventories in counties as well as county to county.

TAXATION OF MERCHANDISE INVENTORIES

Introduction

Tangible personal property is taxed at the general property tax rates of each local taxing district in Iowa. The merchandise held for resale by a merchant, his inventory, is personal property and subject to the tax. The county or city assessor, as the case may be, assesses the inventory of every merchant in his jurisdiction.

Provisions for Assessment of Merchandise Inventories

Section 428.17, Code of Iowa, 1958, provides that "the assessor shall require the production of the last inventory and enter the date thereof in the assessment roll." This section further provides that "if in the judgment of the assessor, the inventory is not correct, or if taken at such time to render it unreliable as to the amount or value of such merchandise, he shall assess the same by personal examination. The assessment shall be made at the same ratio of the average value of the stock during the year next preceding the time of assessment, as is provided by Section 441.13, and if the merchant has not been in business for one year, then at a like ratio of the average value during such time as he shall have been so engaged, and if commencing on January 1, then at the same ratio of the value at that time."

Section 441.13, Code of Iowa, 1958, provides that "all property subject to taxation shall be valued at its actual value which shall be entered opposite each item, and shall be assessed at sixty percent of such actual value."

Actual Value of Real Estate. An explanation of actual value must be considered in the discussion of the assessment of property. Market value is the usual selling price of property. Actual value for purposes of taxation in Iowa does not mean present market value. It is commonly understood by assessors and taxpayers that actual value of real estate is something less than market value. Assessors usually base actual value on the value of real estate prior to World War II, around 1941. Actual value is the value placed on the property by the assessor, and it ranges from 40% to 50%, or less in some instances, of market value. The assessed value of property is 60% of actual value. A sales ratio study conducted by the State Tax Commission for the 1955 tax year for the entire state indicated that rural property was being assessed on the average at 27% of market value and urban property on the average at 24% of market value. The assessed value is the taxable value upon which the millage rate is applied.

Actual Value of Inventories. According to the law as pointed out previously, all property, including merchandise inventories, is supposed to be assessed at 60% of its actual value. However, it is the contention of retailers that the actual value of inventories, as determined by the assessors, is higher than that of real estate. Retailers contend they are assessed anywhere from 30% up to 70% of market value.

During the course of this study, the assessment of inventories in one county was studied. The sales-ratio in this county of assessed value to market value for real estate in the towns in 1959 was between 20 and 25%. Assessed value of inventories to the actual ending inventories of merchants were compared. This showed that in most instances, inventories are assessed at a higher percentage of market value than real estate in this county. Inventory assessments ranged from 10% to 90% of the ending inventory. The majority ranged from 40% to 60% of the ending inventory.

The provision for actual value in the law, which has come to mean something less than market value, brings about inequities in the assessment of inventories both within counties and among the counties of the state, as well as the difference between real estate and inventories.

The assessor makes the assessment of the inventory from information supplied to him by the merchant on a form prescribed by the State Tax Commission. The information to be listed by the merchant includes: inventory as of January 1 of the preceding year, all purchases for the year, inventory as of January 1 of the current year, gross sales and all physical inventories taken during the year. The assessor determines the average annual inventory from the information given him. In actual practice, many times just the beginning inventory and the ending inventory are given to the assessor. The assessor then adds the two inventories together and divides by 2 to arrive at the average inventory. Assessors cannot require the merchant to show them the books or accounting records of the firm, except by order of the district court, but they can take a physical inventory. However, for all practical purposes, it is very unlikely that physical inventories are taken because of the time involved.

Effect of Present Method of Assessment on Slow Turnover Businesses

The result of the present method of assessment is that slow turnover businesses, such as jewelry, hardware, electrical appliance and implement stores, usually pay taxes on larger inventories, at least in relation to cost of goods sold, than fast turnover businesses, such as grocery stores, large super markets, florists, restaurants and taverns. (See Appendix I.)

Two factors which may work to the disadvantage of the slow turnover business are:

1. Obsolescence. Many slow turnover businesses must mark down articles because obsolescence lowers the demand for and therefore the value of the merchandise. Valuation of inventory on a cost basis may be somewhat unfair to these businesses. The law passed in 1959 would appear to show that the legislature is interested in compensating, through tax benefits, for the obsolescence factor.

2. Inflexibility of Inventory. A fast turnover business has a flexible or controllable inventory and might conceivably reduce the inventory at convenient times for tax purposes, in cases where the assessor does not supervise closely the reporting of average inventory. A slow turnover business would find this much more difficult because its inventory is not as flexible. Actual inventory on the tax date is more likely to be equal to the average inventory for a

slow turnover than a fast turnover business. Good assessment practices minimize the disadvantages of inflexibility.

Relief for Slow Turnover Businesses Passed in 1959

Reduction for Obsolescence

Section 66 of Chapter 291, Acts of the Fifty-Eighth General Assembly, granted a reduction of one percent on actual value of merchandise inventories for each number of annual turnovers less than twelve. For example, a business with a turnover of 3 would receive a reduction of 9%, and a business with a turnover of 9 would receive a reduction of 3%. (See Appendix II.) Turnover is the cost of goods sold divided by the average inventory.

Thus, businesses with turnovers less than 12 would have received some tax reduction based on the slowness of turnover. The law indicated that this reduction was granted to reflect abnormal obsolescence. It was not intended to "equalize" inventory assessments beyond this one factor. The general property tax theory of taxing the value of property owned was retained. The new law appeared to be simply an attempt to formalize a method of taking one factor of value (obsolescence) into account. If slow turnover businesses do not have the problem of obsolescence in the degree provided for, then the law constituted special tax benefits for this group.

The application of the reduction for obsolescence could have resulted in some property tax losses, depending on what the present practices are regarding obsolescence. Since no means of replacing the lost revenue was enacted, the burden would have fallen on other property.

Law Declared Null and Void

This provision passed in the 1959 Legislature is not being followed, because an Attorney General's opinion of February 8, 1960 declared it null and void. This resulted from a technical error in drafting the new law.

Proposals Introduced in Other Sessions of the General Assembly

McNeal Bill

A proposal introduced in the 1955 legislative session, House File 41, the McNeal Bill, was an attempt to lower assessments on inventories of slow turnover businesses.

The bill provided a special method for determining the actual value of merchandise inventories for assessment purposes. The assessor would determine turnover by dividing the cost of purchases by the beginning inventory. He then would add the beginning inventory and the cost of purchases and divide by 12. For all businesses with turnovers of 6 or less, this would become the actual value of the inventory. For businesses with turnovers above 6, there would be a reduction schedule which would increase as turnover increased. For example, turnovers of 7, 8, 9, 10, 11 and 12 would receive a reduction of 7, 8, 9, 10, 11 and 12 percent as the case might be. A business with a turnover of 13 would receive a 16% reduction on the actual value of inventory, turnover of 15 would receive 24% reduction, and a turnover of 30 would receive a 60% reduction.

The McNeal bill would have applied to retail inventories, but not wholesale or manufacturing inventories. Enforcement would have depended on the use of state income tax returns. The assessor could have asked the State Tax Commission to verify the figures given him by the merchant on cost of purchases and beginning inventory. If the figures were incorrect or if the merchant did not furnish any figures at all, the state income tax returns would have been used to determine the assessment and the actual value would have been increased 100% as a penalty.

Tax Based on Gross Receipts

One type of tax which might be used in lieu of the property tax on merchandise inventories is the flat-rate tax on gross receipts of merchants.

Option of ½% In-Lieu Tax Based on Net Sales. Two proposals have been introduced in the Iowa legislature in recent years for taxing sales of merchandise at ½ of 1% in lieu of the inventory tax.

House File 315 in 1953 would have given the taxpayer the option of the personal property tax or the ½% in-lieu tax based on net sales. A proposed amendment would have made the ½% rate flexible depending on the millage in the taxing district. The rate would have been increased or reduced by the percentage that the combined millage in each taxing district exceeded or was less than 60 mills.

The ½% tax would have been levied on receipts from sales at wholesale as well as retail. The merchant would have been required to report to the assessor the amount of net sales of merchandise. The tax would have been locally administered and the assessor would have been responsible for levying the tax. An amendment was offered to make certain that the value of the property would be placed on the tax rolls for purposes of determining the debt limit for the taxing jurisdictions.

Mandatory ½% on Retail Sales. House File 655 in 1959 would have levied a mandatory rate of ½ of 1% on all retail sales subject to sales tax, and would have been in lieu of the personal property tax on merchandise inventories. It would not have been applicable to wholesale sales.

The merchant would have been required to report to the assessor all sales subject to sales tax. The assessor could check these figures with the State Tax Commission's sales tax returns. The tax would have been collected locally.

A flat rate tax on gross receipts would increase the tax burden on fast turnover businesses which handle a large volume of goods with a small margin. Likewise, it would probably decrease the tax burden on slow turnover businesses handling fewer goods with a higher margin.

Other Possible Replacements For the Taxation of Merchants' Personal Property

St. John Turnover Tax

A tax starting with gross receipts as a base is the "Turnover Tax" used in St. John, New Brunswick. A percentage of gross receipts is used as the base for the application of the tax rates. The percentage to be used varies among types of businesses, and the average rate of markup is the main factor used in determining the different assessment percentages. Generally, businesses with higher average markups are taxed at higher percentages. Other factors, including the amounts of tax paid under the previous business tax, are also considered.

Percentages of sales used in the tax base vary for retailers from 7 to 25 percent, with 20 percent stipulated for retail businesses not specially classified. For wholesalers, the percentages range from 7 to 12½ percent and apply to sales made within the city, but the minimum tax is 75 percent of the business assessment based on value of premises. The current property tax rate is then applied to the figure resulting from taking the percentage for that business times its gross sales.

Professor Robert M. Clark, author of "The Municipal Business Tax in Canada", reports that the great majority of merchants in St. John prefer the "Turnover" tax to the earlier business tax based on property valuations, evidently on the theory that it varies with the volume of business activity.[1]

Gross Profits Tax

A proposal for a gross profits tax was considered by the National Tax Association a few years ago. No state has adopted such a tax, but it remains worthy of consideration.

[1] Maryland Legislative Council, Committee on Taxation and Fiscal Matters, 1957 Report, p.142.

The proposal was that all merchants engaged in the business of selling merchandise within the taxing jurisdiction would be subject to a "merchants' license tax" based on the gross merchandise profit realized from the sale of their merchandise. This would apply to wholesalers as well as retailers.

Gross profit is equal to net sales less the cost of goods sold. The rate to be applied to gross profits would depend on the revenue needed, but Joseph Martel, who proposed the tax, estimates that the rate would probably be from 1 to 2 percent. The rate would be adopted according to the needs of each taxing jurisdiction. The tax would be in lieu of the personal property tax on inventories.

This type of tax probably follows more closely the ability to pay principle than a gross receipts tax or an inventory tax, but not as close as a tax based on net income.

Taxation of Inventories In Other States

States Exempting Inventories

The states of Delaware, New York and Pennsylvania exempt all tangible personal property from taxation. Merchants' inventories are included in this exemption. The personal property tax was abandoned in Hawaii in 1948.

Merchants' Capital

Tennessee and Virginia exempt inventories from the personal property tax. However, these two states impose an in-lieu tax. Inventories are included in the merchants' capital invested in the business in these two states, and this capital is subject to a special merchants' property tax.

A merchant is required to file a statement under oath stating the amount of capital invested in his business with the county clerk in Tennessee. The amount to be assessed shall not be less than the value of the average amount of stock on hand during the preceding year, which is computed by adding together the highest amount of stock on hand at any time during the year with the value of the lowest amount of stock on hand at any other time during the year and dividing by two, and adding to that figure the actual cash value of all the movable fixtures, safes, desks, office furniture and equipment. If the average stock on hand is less than the capital stock employed by said merchant, he has to pay a tax on the capital stock. The rate of tax is the same as the general property tax rate applied to real estate.[2]

Average Inventory

Many of the states provide for averaging merchandise inventories for property taxation purposes. Some of these states use a monthly average and some use a quarterly average. Some states provide for the optional average inventory which permits the taxpayer choice of assessment on the basis of average inventories or according to the inventory on a specified date.

It is felt that average inventory basis provides greater equality of assessment among types of businesses. The average inventory makes the administration of assessment more difficult for the assessor when he does not have access to taxpayers' records which contain the necessary information.[3]

---

[2] State Tax Guide, Commerce Clearing House, Inc., Chicago, 2nd Edition, 1959, p.2190.

[3] Report of the Governor's Minnesota Tax Study Committee, 1956, p.163.

Inventory on a Fixed Date

Some states assess inventories of merchants as of a fixed date, for example January 1. This provides for easier administration for the assessor. However, it also permits businesses to lower their inventories at that time for tax purposes.

Problems of Assessment of Inventories in Other States

It appears that most of the states encounter problems in the taxation of inventories. First, there is the problem of trying to obtain a suitable method of determining the inventory to be taxed. Should it be on an average basis, a fixed date, a combination of the two, or on the capital invested in the business? The administration of one method of assessment may be better than the administration of the other, however, the assessment may not be as equitable among the various types of businesses. Second, the determination of assessed value to market value or full and true value presents problems to many states as it does to Iowa. From this study it would seem that in this area of assessed value to market value, other states have or are encountering similar problems as Iowa.

The following could very well be said of the taxation of merchandise inventories specifically.

> "In spite of the long history and the fiscal significance of the property tax, it has probably been subject to more criticism than any other tax in the American tax system. Although severely criticized on theoretical bases, the main line of attack by the critics has been directed at the practical administration of the tax. During its long history, the general property tax has acquired the questionable distinction of being one of the most maladministered of taxes. Most of the criticism directed at the property tax has

> been centered around the process of assessment which is at the precise point that there is the greatest amount of discretion exercised."[4]

Assessment of Inventories in One County

In the course of this study, the inventory reported to the assessor of one county as of December 31 was compared with that reported by the taxpayer on his state income tax return. In some instances the amount given the assessor was not the same as reported on the tax return. This was usually true in the case of those businesses with large inventories. For example, a jewelry store gave the assessor the figure of $20,400 as the inventory of December 31. The inventory reported on the income tax return was $41,295.13. This is an extreme example and the study was of only one county of the 99 in Iowa, so it does not provide a random sample for the state. However, it is quite conceivable that this type of thing occurs in the other counties of the state.

In some cases, the assessor is not supplied with all the required information. One taxpayer sent a note to the assessor stating that all figures were the same as the previous year. As stated previously, assessors have no authority to check the records or books of the taxpayer, except by getting an order from district court requiring the taxpayer to make available such records. It is very difficult and almost impossible in some cases for assessors to do a competent job of assessment.

[4]State Supervision of Local Assessment, Bureau of Governmental Research and Service, School of Public Administration, Florida State University, 1957, pp.1,2.

Conclusion

From the previous discussion and the study of the assessment of inventories in one county, the following conclusions can be drawn. Some taxpayers do not report the correct information to the assessor. It would seem that assessors should be given better means to obtain the information they need for assessment when it is not voluntarily supplied to them. This would help the administration of the tax and provide for enforcement of disclosure.

A merchant, who reports to his assessor the correct figures as required, is penalizing himself under the present tax. He is paying his fair share of the tax load and also is paying part of his fellow taxpayer's share. For when some taxpayers do not pay their fair share, the burden is placed more heavily on those who do.

Property taxes make up the largest part of revenue for local governments in Iowa, and local taxing districts are requiring more revenue every year. The taxable value of all retail and wholesale inventories in 1959, collectible in 1960, was $183,688,084.

Inventories are assessed at a higher percentage of market value than real estate. The provision in the Iowa law for actual value leaves the determination of such value to every assessor, because actual value is not defined. There are inequities of assessment between inventories and real estate and inventories in counties as well as county to county.

Perhaps a different means of taxing merchants should be devised, as a tax on gross receipts, gross profits, or capital invested. The following quote from the 1953 National Tax Association Proceedings sums up the taxation of inventories and alternatives to the property tax quite well.

> "A tax on inventories will be of variable impact in relation to sales or gross profits; similarly, a tax on sales or gross profits will be of variable impact in relation to inventory values. Such variations are inevitable because of the varying characteristics of business firms. Two alternative approaches are possible; (1) the classification per ad valorem taxation of types of businesses to compensate for such variations; (2) the levy of a flat-rate tax on some selected measure of business activity (for example, either gross receipts or gross profits) which ignores the variation of that measure in relation to either or both the property or the income of the business."[5]

[5] From the National Tax Association Proceedings, 1953, p.386.

APPENDIX I

Differences in Inventory and Assessment of Inventory For Each $100,000 of Cost of Sales When Turnover Varies from 1 to 40

Cost of Sales	Turnover	Actual or Average Inventory	60% Assessed Value
$100,000	1	$100,000	$60,000
100,000	2	50,000	30,000
100,000	3	33,333	20,000
100,000	4	25,000	15,000
100,000	5	20,000	12,000
100,000	6	16,667	10,000
100,000	7	14,286	8,572
100,000	8	12,500	7,500
100,000	9	11,111	6,667
100,000	10	10,000	6,000
100,000	11	9,091	5,455
100,000	12	8,333	5,000
100,000	13	7,692	4,615
100,000	14	7,143	4,286
100,000	15	6,667	4,000
100,000	20	5,000	3,000
100,000	25	4,000	2,400
100,000	30	3,333	2,000
100,000	35	2,857	1,714
100,000	40	2,500	1,500

APPENDIX II

Differences in Inventory and Assessment of Inventory For Each $100,000 of Cost of Sales When Turnover Varies From 1 to 40, Using the Turnover Reductions - Provided in the 1959 Iowa Law

Actual or Average Inventory	Turnover	Percent Reduction	Actual or Average Inventory After Reduction	60% Assessed Value After Reduction
$100,000	1	11%	$89,000	$53,400
50,000	2	10	45,000	27,000
33,333	3	9	30,333	18,200
25,000	4	8	23,000	13,800
20,000	5	7	18,600	11,160
16,667	6	6	15,667	9,400
14,286	7	5	13,572	8,143
12,500	8	4	12,000	7,200
11,111	9	3	10,778	6,467
10,000	10	2	9,800	5,880
9,091	11	1	9,000	5,400
8,333	12	none	8,333	5,000
7,692	13	none	7,692	4,615
7,143	14	none	7,143	4,286
6,667	15	none	6,667	4,000
5,000	20	none	5,000	3,000
4,000	25	none	4,000	2,400
3,333	30	none	3,333	2,000
2,857	35	none	2,857	1,714
2,500	40	none	2,500	1,500

The Iowa Legislative Research Bureau is a fact-finding and service agency for the Iowa General Assembly. The Bureau does legislative research and reference work and drafts bills for legislators. The general policy for the Bureau is set by the six-member Legislative Research Committee.

Through a small, professionally trained staff the Bureau furnishes services to legislators and conducts research studies at the request of the legislature as a whole, legislative committees or five-member groups of legislators. A joint legislative advisory committee may be appointed to work with the Research Bureau on any interim research study. These committees report their findings to the next legislature. Neither the Research Committee nor the Bureau makes recommendations.

* * * * * * * * * * * * * * *

<u>Members of the Legislative Research Committee</u>

Representative Bert K. Fairchild, Chairman - Ida Grove
Senator Duane E. Dewel, Vice-Chairman - Algona
Senator C. Edwin Gilmour - Grinnell
Representative Robert W. Naden - Webster City
Senator X. T. Prentis - Mount Ayr
Representative Robert F. Wilson - Cedar Rapids

<u>Director of Legislative Research Bureau</u>

Clayton L. Ringgenberg