VALUATION OF BUSINESS INVENTORY UNDER VERMONT'S PERSONAL PROPERTY TAX: A PROPOSAL TO ABOLISH THE EXISTING SYSTEM OF APRIL 1 VALUATION AND TO ADOPT AVERAGE VALUATION APPRAISAL.

For the purposes of the Vermont personal property tax, business inventory is assessed at fair market value as of April 1.[1] As a result, only inventory in the possession of the taxpayer on April 1 is subject to taxation.[2] There is an exception to this general rule of single-date valuation, however, for part-time businesses that are not in operation on April 1. In such cases, appraisals are based on the average value of inventory maintained by these businesses during their periods of operation.[3] The April 1 valuation system has its statutory origin in the late eighteenth century[4] and has remained, in fact, substantially unchanged in its statutory language since 1880.[5] The statute that provides for part-time businesses was passed by the state legislature in 1957. The House bill which initiated this legislation would have, in its original form, abolished April 1 valuations altogether.[6]

The April 1 valuation system has weaknesses which make it inequitable in operation. It has no capacity to take into account seasonal fluctuations in inventory which may peak or bottom out in some businesses around April 1. For example, fuel oil inventories in

1. VT.STAT.ANN.. tit. 32, § 4044 (1970): "Unless otherwise provided, the taxable personal estate contained in the inventory shall be appraised by the listers at its fair market value on April 1."

2. VT.STAT.ANN., tit. 32, § 3691 (1970).

3. VT.STAT.ANN., tit. 32, § 4045:

> If any business is normally operated for a period less than twelve consecutive months and is not in operation on April 1, an inventory shall be filed with the listers at least fifteen days prior to the anticipated annual suspension of such business and the stock in trade shall be appraised for the period of operation so as to represent an average of values of such property during that period in which the business has been carried on.

4. LAWS OF VT., Ch. 48, no. 1, § 2 (1824). This section was originally enacted into law on March 20, 1797.

5. LAWS OF VT., no. 78, § 1 (1880): "All taxable property shall be set in the list at one per cent of its value in money, on the first day of April of the year in which the list is made."

6. H. 293 (1957).

Vermont are usually at a seasonal low at this time of year.[7] The criticism is also frequently made that some businesses use the system to their advantage by purposely depleting their taxable inventories before April 1.[8] The United States Supreme Court recognized many years ago, in the case of *Shotwell v. Moore*, that a single-date valuation method had the potential to create inequities:

> So in the case of merchants engaged in buying and selling goods, the stock on hand on that day might be either the largest or the smallest of any period during the year preceeding. If it were either, a tax intended to be governed by the amount of property owned or held by them during such year would be evidently unjust either to them or to the State.[9]

In order to prevent such practical inequities, it would seem preferable that inventories of all businesses be assessed for the purposes of the personal property tax on the basis of the average value of inventory carried during the tax year. To test this conclusion, however, it is necessary to examine the policy considerations underlying the property tax in order to determine whether these policies are better served by the present system of single-date valuation, or by an average valuation scheme. Since a change in appraisal method would undoubtedly cause a shift in the overall assessed values of business inventory, the impact of such a change on municipal tax rates and on the state economy must also be examined. Finally, a change in appraisal system would necessitate certain administrative reforms. Specifically, there would have to be a change in the format of the standard inventory form which all businesses are required to complete for the purposes of the personal property tax since this form was designed for single-date valuation and does not require the taxpayer to provide any information that actually relates to its average value of inventory.[10]

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7. D. LeSourd and R. Sinclair, State and Local Taxation and Finance in Vermont, 20 (1964).

8. *Id.*

9. 129 U.S. 590, 598 (1889).

10. At this point, it should be noted that under Vt.Stat.Ann., tit. 32, § 3617, (Supp. 1975), towns have been given the option not to tax inventories of finished goods, raw materials and goods in process and in lieu thereof to tax only business machinery, in accordance with Vt.Stat.Ann., tit. 32, § 3618 (Supp. 1975). However, since no towns have, to date, opted to do so, this note is addressed to the structure of the personal property tax as it presently exists.

I. VALUATION OF INVENTORY AND THE POLICIES UNDERLYING THE PROPERTY TAX

It is generally said that when a municipality bases tax assessments on the value of an individual's or a business' real and personal property it is making a decision that this measure of wealth reflects the taxpayer's *ability-to-pay* as well as the value of the *benefits* that the taxpayer receives from the municipality.[11] It must be recognized, of course, that the gross values of real and personal property may not always be an accurate reflection of either *ability-to-pay* or of the value of the *benefits* received.[12] Nevertheless, the property tax may be seen to rest on two interrelated policies: That taxpayers should be required to contribute to the public treasury in proportion to their ability, as measured by the extent of their wealth, and in proportion to the extent that their property benefits from governmental services, as measured by the value of the property. Therefore, the specific question to be addressed is whether these policies are better served by single-date valuation or average valuation. Since there has never been a statewide or industrywide comparison between April 1 inventory values and average values that would provide reliable data by which the two valuation schemes could be evaluated, it may be helpful, for this analysis, to use available examples in which there are significant differences between April 1 values and average values. The data in Table I

It should also be realized that there are alternative forms of taxation to the personal property tax. New Hampshire, for example, has adopted a flat tax rate of 7% on the "business profits" of any enterprise which is required to file a federal income tax return. The "business profit" for the purposes of this tax is the "net taxable income," as determined by federal income tax law. *See* N.H. REV. STAT.ANN., Ch. 77, §§ A:1, A:2, (Supp. 1975). A business profits tax would appear to offer several advantages over Vermont's personal property tax: 1) A tax on profits affects all businesses equally, rather than focusing solely on inventory-intensive businesses; and, 2) Profits can be regarded as a better indication of a business' *ability-to-pay* than is a measure of the gross value of inventory. *See* note 12 *infra*.

11. J. BONBRIGHT, THE VALUATION OF PROPERTY, 453-54 (1937).

12. *Id.* at 454-55. Bonbright points out in his treatise that the *ability-to-pay* theory is most susceptible to attack. The argument is frequently made that the value of a taxpayer's tangible property is no longer an acceptable indication of the taxpayer's overall wealth and that annual income should serve as the tax base upon which municipal taxes are assessed. Bonbright indicates another inconsistency in the *ability-to-pay* rationale in that quite often a taxpayer's property is subject to a substantial mortgage, or another comparable form of debt liability. In light of situations such as this, the *ability-to-pay* theory would be logical only when taxpayers are allowed to deduct their debts from the market value of their property and thus be subjected to taxation only on their *net* wealth.

shows the comparative results of April 1 valuation and average valuation as applied to five businesses.[13] The figures in column 2 are the April 1 inventory values, as taken from the grand lists of the towns in which these businesses are located. The "average values" in column 3 are averages, in each case, of various inventory values taken from each business' corporate income tax return for the same year.[14] A hypothetical tax rate of $7.00 per hundred dollars of listed value has been applied to both sets of values and the resultant taxes are set out in columns 4 & 5.[15]

TABLE I

Column 1	Column 2	Column 3	Column 4	Column 5
Type of Business	4/1/74 Inventory Values	Average Inventory Values	Tax on 4/1/74 Values	Tax on Average Values
1. Retail Grocery	$ 102,031	$ 154,910.00	$ 3,571.08	$ 5,421.85
2. Large discount department store	$ 437,640	$ 812,533.50	$15,317.41	$28,438.67
3. Large wholesale building supplier	$ 358,430	$1,127,245.00	$12,545.05	$39,453.57
4. Large manufacturer	$1,099,000	$2,068,317.50	$38,465.00	$72,391.10
5. Large manufacturer	$ 524,789	$1,013,526.00	$18,367.61	$35,473.41

Each of these businesses could anticipate a substantial rise in

13. The information in columns 1 through 3 was supplied by the office of Robert G. Lathrop, Commissioner of Taxes, Montpelier, Vermont.

14. The actual inventory figures taken from the corporate tax returns are as follows:

1) Retail grocery:	$ 135,645 (6/25/73) $ 174,175 (6/30/74)
2) Large discount department store:	$ 769,578 (7/1/73) $ 855,489 (6/29/74)
3) Large wholesale building supplier:	$1,172,495 (1/1/74) $1,081,955 (12/31/74)
4) Large manufacturer:	$2,142,531 (10/1/73) $1,994,104 (9/30/74)
5) Large manufacturer:	$1,009,279 (1/1/74) $1,017,773 (12/31/74)

15. "Listed value" is 50% of appraised value, VT.STAT.ANN., tit. 32, § 3481, *as amended*, (Supp. 1975). Thus the tax rate of $7.00 per hundred dollars of listed value is applied to 50% of the inventory values in columns 2 and 3. Also the rate of $7.00 per hundred dollars of listed value is an approximate average of property tax rates in Vermont. *See* CCH STATE TAX REP., VT. ¶ 71-001.

taxes under a system of average valuation appraisal.[16] There would be an increase in the aggregate quantity of taxable property in each business, and thus, an increase in taxes. Conversely, businesses which have April 1 inventory values that are high in relation to average values would receive a benefit from average valuation appraisal in the form of lower taxes. The question thus becomes whether there is any justification under the *benefits* theory and the *ability-to-pay* theory for choosing average valuation and causing such changes in the tax burden.

A. *The Benefits Theory*

Under the single-date valuation system, a business pays the same amount of tax regardless of whether its April 1 inventory value is high or low in relation to its average value. Take the example of the "large wholesale building supplier" from Table I. This business was taxed on its 4/1/74 inventory of $358,430 despite the fact that its average inventory during 1973 and 1974 was $1,127,245. Now assume that there was another building supplier in the same town and that although this business also had a 4/1/74 inventory of $358,430, its 1973-1974 average inventory was only $200,000. The logical inconsistency of the single-date valuation system becomes obvious in light of the fact that both of these businesses would have paid exactly the same amount of tax, even though one of them had an average inventory that was almost 600% greater than the other. If value of inventory is assumed to be in proportion to the value of *benefits* received from the municipality during the course of the tax year,[17] then the inventory value to be used in computing tax assessments must be average value. Although there may not be a perfect correlation between average values of inventory and *benefits* received, there is clearly no correlation at all when appraisals are fixed at exceptionally high or low values.

16. The increases, expressed as percentages, are:

1) Retail grocery:	51%
2) Department store:	85%
3) Building supplier:	214%
4) Manufacturer:	88%
5) Manufacturer:	93%

17. J. Bonbright, *supra* note 11.

B. *The Ability-to-Pay Theory*

The *ability-to-pay* rationale is based on the assumption that businesses and individuals with more valuable property can afford to pay higher taxes than can the owners of less valuable property. The value of property is regarded as the best indication of "wealth" and, hence, capacity to pay taxes.[18] The criticisms of single-date valuation with respect to the *benefits* theory apply with equal force in the context of the *ability-to-pay* theory. Commercial inventories fluctuate greatly, as exemplified by the five businesses in Table I. If any inventory value is to be regarded as an indication of a business' "wealth" during the course of the tax year then it must be average value. There is no correlation between "wealth" and atypically high or low inventories..

From a policy perspective, it is thus clear that the policies underlying both the *benefits* theory and the *ability-to-pay* theory are better served by a system of average valuation than by single-date valuation.

II. The Impact Of Average Valuation On Municipal Tax Rates And The State Economy

Any change in the method of appraisal is certain to have a direct effect on at least some businesses' assessed values of inventory and, thus, an effect on municipal tax revenues and tax rates. There will be an indirect, adverse effect on the state economic base if these increases in taxes cause a cutback in investment and/or increased unemployment.

A. *Effect on Municipal Tax Rates*

To the extent that April 1 values are reflective of average values, there would be no change in the amount of tax paid by businesses if average valuation were implemented across the board. However, to the extent that April 1 values are lower than average values, as in the case of the Table I businesses, average valuation would cause an increase in assessed values of inventory. This would have the effect of expanding the tax bases in the towns in which these businesses are located. Assuming that the towns' revenue

18. Id.

needs remained constant, tax rates could then be lowered. Since the personal property tax base would have increased in proportion to the real property tax base, there would be a shift in the municipal tax burden: Taxes on real property would be lower. The overall result of this change would be an equitable one in light of the *ability-to-pay* and *benefits* policies underlying the property tax, even though the change would impose an unanticipated burden in the first year on businesses with April 1 inventory values lower than average values.[19]

B. *Effect on the State Economy*

The type of tax increases that would be experienced by the five businesses in Table I could conceivably result in their relocating in states that do not have a personal property tax.[20] Even if these businesses chose not to relocate, the increased taxes might have to be passed along to retail and wholesale purchasers in the form of higher prices. There could be an adverse effect if this rise in prices caused a decrease in sales. Decreased sales could precipitate a cutback in the level of business and increased unemployment if workers are laid off or fired in the face of slackening demand.[21]

In evaluating what has been discussed in this section and the preceding section, it can be seen that the legislative decision of whether to extend average valuation to all businesses must be based on a consideration of competing interests. On the one hand, there are the desirable results of preventing some businesses from enjoying unwarranted advantages from seasonal fluctuations and/or purposeful depletions of inventory and of achieving an equitable distribution of the municipal tax burden. On the other hand, there is the potentially negative economic impact that such a change might

19. The actual result in any given municipality would be a function of two variables: *First*, the aggregate increase or decrease in personal property tax revenues caused by the shift to average valuation; *Second*, the percentage relationship of revenues from personal property taxation to total municipal property tax revenues. The larger the percentage that personal property tax revenues form of total property tax revenues, the greater would be the impact on tax rates. According to information compiled by the Vermont Department of Taxes, personal property tax revenues in 1974, as percentages of total property taxes raised, ranged from an insignificant .1% in several towns to over 30% in the towns of Essex, Hancock and Springfield.

20. *See* note 15 *supra*, for the projected increases in taxes for these businesses.

21. For a general discussion of the impact of taxation on the economy and business, *see* BACH, ECONOMICS, AN INTRODUCTION TO ANALYSIS AND POLICY, 593-613 (1963).

have. The scope of this economic impact cannot be determined without further data on the extent to which April 1 values differ from average values in all businesses in the state.[22] The legislature could minimize this potentially adverse impact, however, by making the change to average valuation prospective and thereby allowing businesses sufficient time for financial planning to meet the sudden increase in taxes.

III. Administrative Reform Necessary To Implement Average Valuation

The assessment process under the personal property tax commences with the taxpayer/business submitting to the local lister a completed inventory form, which contains the taxpayer's stated *book value* and *fair market value* of each category of taxable property.[23] This standard form is supplied by the Commissioner of Taxes.[24] For full-time businesses, the values to be stated in the form are April 1 values.[25] Although the same form is presently used by part-time businesses, which are supposed to be assessed on average inventory values, these businesses are not required to provide any specific information that actually relates to average inventory but are only required to file a statement reflecting inventory values prior to the close of operations.[26] Although the local lister is not required to base his appraisal on the stated values reported in the inventory form, the practical result of the present system is such that he generally does so, making no attempt to ascertain true values by means of an independent appraisal.[27]

If a system of average valuation is adopted for all businesses,

22. This could be accomplished by making a statewide comparison for all businesses, as was done with the five businesses in Table I. Practical problems arise, of course, from the enormity of such a task.

23. VT.STAT.ANN., tit. 32, § 4004 (1970).

24. This standard form is reproduced in CCH STATE TAX REP., VT. ¶ 21-415.

25. The directions on the form specifically require the taxpayer to list the value of his taxable property as of April 1.

26. VT. STAT. ANN., tit. 32, § 4045 (1970).

27. No statewide records are maintained as to exactly how often listers base their appraisals of personalty on something other than the taxpayer's stated value. Unofficially, however, according to officials in the Property Tax Division and the Audit Division of the Department of Taxes, the general procedure followed in almost all cases by local listers is to accept, at face-value, the stated values of inventory submitted by the taxpayer.

the format of the standard inventory form should be changed so that businesses would be required to provide some intelligible data relating to average inventory value.

A. *The Existing Procedure*

Once the local lister has the completed inventory form in front of him, he has the authority to either base appraisals on the business' stated values or to undertake to make an independent appraisal as best he can.[28] In what manner or on what basis is he to actually make such an independent appraisal?[29]

First, he does have the authority to make a personal examination of the property.[30] This presupposes, however, that the lister can take an actual physical count of the goods in question. When farm animals were subject to taxation under the personal property tax, they formed a large, and often dominant, share of the tax base.[31] A lister could readily ascertain the number of dairy cows that a taxpayer possessed by making a personal examination of the herd.[32] But in trying to determine the average quantity of goods and materials carried by a merchant or manufacturer during the tax year, a lister cannot conduct a firsthand examination of property that is no longer in the possession of the taxpayer.

In addition to making a personal examination, the lister is empowered to request detailed information from the taxpayer. However, he can request such information only when he believes that it

28. VT.STAT.ANN., tit. 32, § 4084 (1970).

29. Most likely, a lister will first turn for guidance to the VERMONT LISTERS AND TAX COLLECTORS HANDBOOK (1970). Page 20 of the *Handbook*, the commentary to VT.STAT.ANN., tit. 32, § 4084 (1970), instructs the lister as follows:

> Inventories sent in by taxpayers can be accepted or not by the listers. If the listers *feel* an inventory does not represent a true estimation of value, the listers can adjust the taxpayer's figures to reflect what they *feel* the true value to be. . . . (emphasis added)

30. VT.STAT.ANN., tit. 32, § 4041 (1970).

31. For example, in the state grand list for 1824, the total appraised value for all livestock was $1,138,946 as contrasted with a total appraisal of only $797,240 for all "mills, stores, merchants and traders."

However, farm animals were statutorily exempted from the personal property tax in 1971. *See* VT.STAT.ANN., tit. 32, § 3802, (Supp. 1975).

32. The present Chief of Property Taxes, Department of Taxes, Mr. George O'Brien, recollects that when he was a lister he spent a substantial amount of his working time appraising dairy cattle herds. Interview, Montpelier, Vermont, Feb. 2, 1976.

is "necessary."[33] The difficulty here, in regard to average valuation, is that owing to the paucity of information supplied by the business, the lister is not in a position to know whether the stated value is an accurate reflection of average value or whether more information is "necessary" to make an accurate appraisal.

B. *Suggested Changes*

The burden of deciding whether more information is "necessary" could be lessened by requiring the business to initially provide some reliable figures that actually relate to the average value of inventory that it carries. Then at least the lister would have something to compare against the stated value and he would be in a better position to know whether further information was "necessary."

One approach would be to require the business to include a certified statement of the dollar amount of the inventory as set out in the business' latest federal income tax return. This is the procedure followed under the Nebraska personal property tax.[34] Although such income tax inventories would not be conclusive proof of value for the purpose of the personal property tax, they would provide the lister with an additional tool for evaluating the stated value of taxable inventory.[35]

In Oregon, when a business employs average valuation in filing inventory statements, it must use figures from "not less than twelve uniform accounting periods" and these accounting periods must "represent the regular and ordinary accounting practice of the taxpayer."[36] An Oregon-type rule guarantees that the stated values will have some statistical reliability.

It should be noted that such changes could be effectuated without statutory amendment. Changing the format of the inventory form is clearly within the power of the Tax Commissioner.[37]

33. VT.STAT.ANN., tit. 32, § 4001(b) (1970).

34. NEB. REV. STAT. § 77-1231.01 (1971).

35. In L. J. Messer Co. v. County Board of Equalization, 171 Neb. 393, 401, 106 N.W.2d 478, 485, (1960) the Nebraska Supreme Court held that the income tax inventories so furnished were not to be regarded as conclusive as to actual value but were to be used by the taxing authorities along with a system of inspection of inventories and business records in order to determine actual value.

36. ORE. REV. STAT., § 308.292 (1974).

37. VT. STAT.ANN., tit. 32, § 4001(a) (1970):

Only the lister has the power to accept the stated values reported in the inventory form or to make an independent appraisal.[38] The result of the present system is that listers very seldom question the stated values of inventory submitted by businesses. Thus, the practical effect of the present system is that appraisal values of businesses' inventories are ordinarily determined by the taxpayers. Such a procedure would be considered shocking with respect to the taxation of real property,[39] yet this is precisely the situation that exists, *de facto*, under the personal property tax. If taxpayers were required to provide the type of information suggested above, listers would be in a better position to make independent appraisals. Even if average valuation is not made the basis of appraisal for all inventories, the form should still be changed so as to provide this information for part-time businesses, which are presently taxed on average values. The single-date valuation system does not lend itself to reform in this way since information relating to average values would be of little assistance so long as the basis of appraisal is the inventory value as of April 1.

IV. Conclusion

In summary, it has been suggested that an equitable and rational system of personal property taxation can only be achieved with an appraisal system based on average values of inventory. It has also been noted that a significant change in appraised values of inventory under an average valuation system would result in a pro-

> Such forms shall be formulated by the Commissioner, and, among other things, shall contain suitable interrogatories requiring each taxpayer to furnish therein a brief statement of all his taxable property, real and personal, and such other information as will enable the listers or appraisers to appraise such part thereof as is required by law. . . .

38. Royalton Taxpayers' Protective Ass'n v. Wassamansdorf, 128 Vt. 153, 159, 260 A.2d 203, 206 (1969). In this case the Vermont Supreme Court held:

> Further, the duty of the listers is to act upon their own best discretion and judgment, and the law in no way permits them to delegate that responsibility to others. It is the duty and responsibility of the listers, alone, to make such determinations.

39. Although the standard form submitted by businesses pursuant to the personal property tax also contains provision for the businesses to state the value of their *real property*, such stated values are clearly not as controlling as are the stated values of inventory, since real property lends itself to firsthand examination by listers much more readily than does a commercial inventory.

portionate change in municipal tax rates and a fairer distribution of the municipal tax burden. Against these considerations of equity and policy stands the possibility that change to a system of average valuation might present adverse economic consequences. Finally, there is a need to change the format of the standard inventory form in order to accommodate a system of average valuation appraisal.

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