

Fair or Foul?

The dark store theory and its impact on property tax assessments in Wisconsin.



Tom Larson | January 13, 2017

In Wisconsin and other states throughout the country, national retailers such as Walgreens, CVS, Lowe's, McDonald's, Target and The Home Depot have successfully challenged their property tax assessments to lower their property tax bills using an appraisal method known as the Dark Store Theory (DST). These successful court challenges have lowered the property tax bills for these national retailers by millions of dollars. As a result, local governments have raised the property taxes of other property owners — namely homeowners — to make up the difference. If the legal challenges continue, local assessors maintain that homeowners could see their property tax rise by hundreds of dollars each year.

Local governments assert that the DST is a creative loophole used by national retailers to avoid paying their fair share of property taxes. On the other hand, commercial property owners and real estate professionals argue that national retailers have been overcharged for years and assessments based on the DST better reflect the fair market value of their property. Several lawmakers will likely introduce legislation this session to stop or limit the use of the DST to assess commercial property, but support for such legislation is unclear.

This article provides an overview of the DST, some of the related policy arguments in support and in opposition of the DST, and its impact on property tax assessments.

Background

Under the DST, a commercial property — primarily retail property — is valued for assessment purposes as if it were empty and without the business that currently occupies it. In other words, the property is valued as if it was (a) completely dark, without the current tenant/occupant, lease terms or sales price of the property, and (b) subject to the current market conditions and locational characteristics of other, similar property competing for tenants in the open market.

In 2004, Walgreens began challenging its property tax assessments in Wisconsin using the DST and, ultimately, convinced the Wisconsin Supreme Court that its theory was correct. See *Walgreens v. City of Madison*, 2008 WI 80. Since the Supreme Court's ruling, Walgreens and other retailers have successfully challenged numerous property tax assessments in over 100 communities across the state.

Assessors maintain that a reduction in property taxes by Walgreens and other retailers will result in a significant property tax increase for other properties in these communities. The table below shows what assessors estimate the tax increases homeowners in select communities will experience when the DST is fully implemented. Calculations are based on the amount of national chain retail space, 2015 mill rates and median home values:

City	Estimated Tax Increase	Average Increase Per Home Per Year
Brookfield	5%	\$233.50
Hudson	9%	\$374.58
La Crosse	7%	\$197.12
Oconomowoc	8%	\$360.96
Pleasant Prairie	17%	\$892.50
Wauwatosa	7%	\$382.12
West Bend	8%	\$253.89

The dark store theory explained

The underlying premise of the DST is that a retail property's assessed value cannot be determined by evaluating only the construction costs, lease terms or sales prices of the subject property. Rather, the fair market value of the property for assessment purposes must be determined by evaluating what other similar properties are selling and leasing for in the area. Thus, the DST relies heavily on the sales comparison approach, maintaining that other approaches to value, such as cost and income, fail to account for the fact that many properties are custom built for the specific needs of the current owner or occupant of the property and may have a reduced value to other occupants or owners, for example, fair market value. DST supporters claim the methods used to assess many retail properties are not accurate for the following reasons:

Recent sales and current leases of the subject retail property do not accurately reflect fair market value: Local governments often use a recent sale or current lease of retail properties as a good indicator of fair market value. However, DST supporters maintain that sales and leases of retail properties are often used as a financing and investment vehicle and thus do not necessarily represent what someone would be willing to pay for the property in an arm's-length transaction. More specifically, retail properties are often subject to a sale-leaseback agreement wherein a large national retailer pays to construct the property and builds the property to its exact specifications and needs. After the building is constructed, the retailer will sell the property to an investor at the price for which the store was constructed with the agreement that the investor will lease the store back to the retailer. This arrangement provides the investor with a steady investment stream and the retailer with a retail store built to their specifications to operate over an extended number of years as well as instant financing for their next construction project. Thus, in such cases, the sale price or lease amount of the retail property represents what the specific retailer is willing to pay for a property specifically designed and constructed to meet the specific needs of that retailer — not what other retailers are willing to pay to occupy the property.

The cost of construction does not accurately reflect fair market value: Local governments often use the actual construction costs of retail property to determine the assessed value. However, DST supporters argue that because these retail properties are built to the exact specifications and needs of the retailer, they contain “superadequacies,” or “functional obsolescence,” that is worth a lot to the current store occupants but would add nothing to the store’s selling price or lease value once the current occupant moves out. An example of such superadequacies would be a unique shape of the building that makes it easily recognizable as a building of the current business, or extremely high ceilings for forklifts and room for extremely high shelving. DST supporters argue these superadequacies hurt the sale price because not only will a future buyer not want them, but a future buyer likely will have to spend additional money to remedy the issue.

DST supporters assert these properties are custom built with custom features that only the current occupant would value. Therefore, the price paid to construct the property takes into account the value to the current occupant and does not consider that no one but the current occupant would pay for these superadequacies. Instead, DST supporters claim the store should be valued as if it was not occupied by the current business, for example, as if it were completely dark.

Sales of similar vacant property around the region and county are better comparables: DST supporters often base their valuations largely on the sales of other vacant retail property from around the region or country as their comparable sales. When a big-box store is closed, it often indicates there is no longer market support for that particular use at that particular location. In many cases, the stores sell at a fraction of their original costs and are converted into a different second-tier use such as a church, furniture store, or indoor flea market. DST supporters contend that this lower sales price and subsequent second-tier use is because there is not a market for big-box stores or other uniquely built commercial properties due to their functional obsolescence.

However, local governments argue that these retail properties are vacant for extended periods of time because these properties carry restrictions in their deeds that greatly limit the types of buyers that could utilize the property after purchase. For example, a deed for a former Lowe’s property will likely carry restrictions prohibiting the property’s use as a home improvement store, lumber yard, garden center or other competing business. These contractual provisions ensure that superadequacies, such as high ceilings to allow the use of forklifts and high shelving, remain functionally obsolete to the restricted pool of limited buyers. Thus, some argue these retailers are attempting to reap a property tax benefit as a result of a self-inflicted wound.

Proposed legislation

To minimize possible shifts onto residential and other commercial properties resulting from the DST, legislation likely will be introduced this session that allows local governments to use the actual lease revenues and recent sales of retail properties in determining assessed values like they did prior to the successful court challenges. However, such legislation likely will be scrutinized closely and will raise questions and concerns among lawmakers who are generally cautious about making any changes to the property tax assessment practice that will benefit some property owners at the expense of others.

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