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Dark Store Theory…*potential impact on retail assessed valuation*

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Executive Summary

Over the past few years, big-box stores, including Home Depot, Lowe's, Menards, Walmart and Target, have taken a new, aggressive approach to challenging the assessed value of their properties. Dubbed the "Dark Store Theory" by assessors, these retailers are claiming their buildings are functionally obsolete to other users due to their specific characteristics. The retailers have been successful in certain parts of the country, resulting in large property tax refunds and lost future revenue. Given the challenges brick and mortar stores face from Amazon and their own e-commerce efforts, the belief is these challenges will continue and expand to other parts of the country. Some municipalities are more vulnerable than others, especially those where current law limits property tax growth or smaller communities where big-box stores are some of the largest taxpayers. Municipalities would be wise to understand the risks, get out in front of the issue at the state level, and, if appropriate, conduct contingency planning.

Introduction

Municipalities are used to property owners of all kinds challenging their assessed value. After all, every state has their own formal process for notifying property owners of their assessed value on an annual basis and providing a formal process for challenging the value. But over the past few years, big-box stores, including Home Depot, Lowe's, Menards, Walmart and Target, have taken a decidedly more aggressive approach in challenging their assessed value. The actions of these retailers – cleverly dubbed the "Dark Store Theory" by assessors – has a potential profound impact for all levels of government and reshape how taxes are allocated.

The Issue

At the heart of the issue is simply how retail properties are valued. Generally accepted assessing practices values properties on their "highest and best use," which inherently assumes commercial properties are operating. But over the last few years, these retailers have claimed the buildings they occupy are built-to-suit and constructed with such specific features, that they are functionally obsolete to any other potential user. As a result, they should be valued as if they are empty and abandoned – a Dark Store.

Assessing Methods

To understand the argument, a brief overview of commercial property assessment methods is warranted. There are three methods to determine the assessed value of commercial property:

1. Cost Approach – The cost method adds the purchase price of the land and the cost of construction, less annual depreciation. The cost approach does not take into consideration the amount the property would garner in an arms-length transaction.
2. Income Approach – The income method utilizes the revenue the property generates to determine a value, regardless of the cost of constructing the building.
3. Sales Comparison – The comparable sales method looks at the sales prices of comparable poperties that have sold in the market and is the most common method used for property tax assessment purposes.

Assessors use all three methods when setting a value for a commercial property. Both facts and subjective, professional judgements on behalf of assessors are involved with all three methods. The question is: What method should be used or given greater weight?

The Retailer's Argument

Modern day big-box stores range in size from 50,000 – 150,000 square feet. The stores are typically new construction with specific features that can include grocery stores, doctor's offices, bank branches and auto shops. The retailers claim these buildings have no other functional purpose or would require a massive investment by a new user, that the assessed value should be significantly discounted. In other words, the cost method overvalues the true market value of the building. In addition, their argument is bolstered by the fact that it is increasingly difficult to re-tenant a building due to the growth of e-commerce.

Complicating the issue is a common financing structure that is oftentimes used to finance original construction. At the risk of over-simplification, new construction is internally leased at above-market rents, which increases the assessed value under the income method. Retailers claim this arbitrarily inflates their income and thus, their assessed value.

Lastly, retailers point to the market value of shuttered stores that have sat empty for months, if not years, and sell at a deeply discounted amount.

The Assessor's Argument

First and foremost, as previously stated, general accepted assessing practices consider the highest and best use for a building. And if a business is operating and profitable, assessor's claim it violates the basic concept of highest and best use.

Secondly, assessor's claim the comparable sales argument presented by the retailers is spurious because the shuttered stores are oftentimes in a less desirable location or the retailer has purposively sold the building to a non-competitor, which likely isn't the highest and best use for the building. As a result, the sale of the previous building is not a good comparison to value the new building.

A Brief History

Based on research by Springsted, assessment appeals based on the dark-store argument have been isolated to Michigan, Indiana, Texas, Wisconsin, Florida and New York. The first known case in which a major retailer successfully challenged their assessed value was Target in Detroit, Michigan, back in 2010. Since then, Michigan has been on the front line of the debate, with the Michigan Tax Tribunal largely ruling in favor of retailers, which has resulted in municipalities at all levels returning over $200 million in past property taxes.

In 2007 the Indiana Supreme Court declined to review a lower court ruling that lowered the value of a Kohl's store by 40% and required the County to repay three-years of taxes. The decision also validated the dark store assessment methodology under current law, which will allow appeals to continue in the state.

Texas counties, including Harris County (Fort Worth), have been involved in arbitration proceedings with Lowe's since 2016, which has also resulted in lower assessed values in a state that is heavily dependent on property taxes.

Surprisingly, given the crux of the dark-store assessment argument that buildings are functionally obsolete to other users, smaller retailers such as CVS and US Bank have challenged their assessment value using the same argument.

The Most Vulnerable Municipalities

While every municipality in every state is affected by reduced market values, the impact will vary greatly. Below are the factors that will dictate the extent of the impact:

1. Property Tax Assessment Limits – Municipalities that operate under state imposed property tax limits, including constraints on tax rates, tax levies and/or assessed values, will not be able to backfill the lost revenue without a change in current law.

   When Big-Box is in the Top 10 – Big-box stores including Walmart and Target are often one of the top ten taxpayers in communities with smaller tax bases and populations. These communities are oftentimes regional centers with populations ranging from 5,000 – 30,000 with a market value under $1 billion. A recent analysis conducted by Springsted of eleven regional centers fitting these characteristics showed that big-box retailers comprised between 2% - 4% of the City's tax base.

2. Diverse Mix of Property Classes – Communities with a more diverse mix of property types - such as commercial, residential and industrial - will be better insulated from potential reductions in commercial values.

3. Level of Reliance on Commercial Property Taxes – Most states already place a higher rate on commercial properties compared to residential; however, some do more than others and, therefore, are more reliant on their revenue.

4. Current (and Future) State Laws – Current and future state laws will have a significant role in determining any impact on municipalities in their state. In some states, current law holds school districts harmless for any adverse tax judgements in their jurisdictions. No doubt some states will attempt to come to the rescue of municipalities legislatively in response to actions by retailers or court decisions, while other state legislatures and executives will welcome the prospect of lower property taxes for businesses.

What's Next

With brick and mortar stores continuing to be challenged by Amazon and their own e-commerce efforts, it seems inevitable that these retailers will seek to cut costs whenever possible. And given the fact that they have been successful in different regions of the country, the chances seem high that challenges to assessed values are on the horizon.

In January 2018, Standard & Poor's published an article saying the dark-store tactic could put pressure on the budgets and credit quality of U.S. municipalities. They noted "the potential exists for the growing use of dark store theory to contribute to widespread fiscal pressure for certain types of issuers." Municipalities at all levels would be wise to understand the issue, quantify the potential risk and prepare contingency plans, and consider legislation that could mitigate their risk.

If you would like more information on this topic or would like assistance identifying the potential risk to your community, please feel free to contact Springsted at 651-223-3000 or your Springsted representative directly.