Dark Store Theory—How to Stop It from Coming to a State Near You!

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Most ad valorem property tax systems value real property in the fee simple. This means that the property is valued by assuming absolute ownership, unencumbered by any other interest or estate. It also requires that the property be valued based on market value. In the case of big-box retail, however, many assessors are advocating for a new "Dark Store Theory" that would effectively value big-box retail in the leased fee rather than in the fee simple. In other words, proponents of the Dark Store Theory attempt to value big-box retail properties based on the value the property has to the current user ("value-in-use") instead of the value the property has on the open market ("value-in-exchange"). This generally leads to increased assessed values and, in turn, increased tax revenue. The issue is whether assessing a property based on its value to the current user, as opposed to its value to the market, violates the uniformity of taxation requirement of most state constitutions.

Introduction

Under most ad valorem property tax systems, real property is valued in the fee simple, according to generally accepted real estate appraisal practices. This means that the property is valued assuming absolute ownership unencumbered by any other interest or estate, such as a lease or mortgage, and this requires that the property be valued based on its market value, or its "value-in-exchange."

In the case of big-box retail properties, however, many state and local property tax assessors ("assessors") have begun to advance a new theory known as the "Dark Store Theory."

The Dark Store Theory argues that sales of vacant big-box retail properties may not be used as comparables to value big-box retail properties that are currently in operation.

By prohibiting the use of vacant comparable sales, assessors are attempting to shift the valuation methodology from a method focused on the required fee simple value-in-exchange to a method focused on the actual "value-in-use." Big-box retail properties, however, are often subject to long-term above-market rate leases.

Therefore, the attempt to value these properties based on their value-in-use inevitably leads to a leased fee valuation, rather than a fee simple valuation, which frequently results in higher assessed values.

This discussion explores how and why the concept of the Dark Store Theory developed and the prospects for its future application to property tax assessments of big box retail properties.

Valuing the Fee Simple Interest

Most states levy ad valorem property taxes based on the assessed value of the fee simple estate. The *Dictionary of Appraisal of Real Estate* defines fee simple as "Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat."[1]

A number of recent judicial decisions from various states focus on accepted real estate appraisal methodology in valuing the fee simple estate of big-box retail properties.

For example, in *Kohl's Indiana L.P. v. Howard County Assessor*, the Indiana Board of Tax Review (the "Indiana Board") issued a decision relating to the assessed valuation of an 88,000 square-foot Kohl's department store.[2]

In its decision, the Indiana Board held that when selecting sales comparables, the "property should be measured against properties with a *comparable* use, as opposed to properties with *identical* users."[3]

The Indiana Board then found that "sales of vacant big boxes used for generally similar retail purposes both pre- and post-sale, if otherwise comparable and properly adjusted, may be employed in determining true tax value."[4]

The Michigan Tax Tribunal (the "Tribunal") also issued several recent decisions pertaining to the valuation of big-box retail stores. In *Ikea Property Inc. v. Township of Canton*, the Tribunal rejected the use of a sale, in part, because it was a "leased fee sale."[5]

Many of the comparable sales relied upon by the Tribunal were sales of vacant big-box properties formerly occupied by big-box retail stores.[6]

The following year, in *Kohl's Department Stores, Inc. v. Township of Frenchtown*, the Tribunal again rejected the consideration of built-to-suit leases and sale lease-backs to value property in the fee simple.[7]

The Tribunal explained that a "built-to-suit lease is simply not representative of the amount for which the real property would sell if it were vacant and available to be leased."[8]

The Tribunal continued:

> In applying a market approach, the appraiser should find sales of second-generation uses of these properties . . . If these sales are not distress sales and share the same highest and best use as the subject if vacant and available to be leased, then they will provide credible evidence of the subject's market value.[9]

The Tribunal also issued a decision in *Kohl's Department Stores, Inc. v. Township of Kochville* on the same day, in which it distinguished between the two concepts of value-in-use and market value.[10]

The Tribunal stated: "a property that has been custom built for the current occupant will usually have a value-in-use that is higher than the property's market value, as value-in-use is a function of the current use, regardless of the property's highest and best use."[11]

The Michigan Court of Appeals agreed with the Tribunal's acceptance of vacant big-box properties as sales comparables. In *Lowe's Home Centers, Inc. v. City of Grandville*, the Michigan Court of Appeals emphasized that fee simple valuation requires property to be valued as vacant and available, holding, in relevant part, that it is improper to consider:

1. customer sales receipts because "vacant and available properties do not generate customer sales receipts" or
2. whether "an owner actually intends to sell the property being valued"[12]

In a companion case, *Lowe's Home Centers, Inc. v. Township of Marquette*, the Michigan Court of Appeals held that a proper fee simple analysis of two big-box stores owned by Lowe's and Home Depot, respectively, required the subject properties to be valued as "vacant and available for sale, as opposed to occupied."[13]

Valuing the properties as a Lowe's and Home Depot store, rather than as a vacant big-box retail store, "confuse[s] the distinct concepts of fair market value (i.e., value-in-exchange) and value to the owner (i.e., value-in-use) by treating them as one in the same."[14]

The distinction between value-in-use and value-in exchange as it relates to the concept of fee simple also arose in other jurisdictions, including New York, Wisconsin, and Kansas.

In *Matter of Home Depot U.S.A. Inc. v. Assessor of the Town of Queensbury*, the New York Supreme Court, Appellate Division, affirmed the lower court's acceptance of seven vacant big-box stores in the sales comparison approach and the rejection of several built-to-suit leases in the income approach.[15]

In *Walgreens Company v. City of Madison*, the Supreme Court of Wisconsin (the "Court") found that the circuit court erred in accepting sale-leaseback and built-to-suit sale transactions and leased-fee comparables because they do not reflect "market rates."[16]

The Court concluded that "tax assessors must refrain from including creative financing arrangements under a specific property's lease in their valuations of that property."[17]

Similarly, the Kansas Board of Tax Appeals (the "Kansas Board") concluded in *In re Equalization Appeal of Prieb Properties, L.L.C.*, that "built-to-suit leases are financing arrangements for new construction and generally do not provide a reliable

indication of value for big box facilities that are resold on the secondary market."[18]

Accordingly, the Kansas Board determined that in order to "distill the value of the fee simple estate," built-to-suit leases and sales must be ignored.

The Origin of "Dark Store Theory"

Although many courts emphasized that generally accepted appraisal methodology is permitted, if not encouraged, for the consideration of vacant stores as sales comparables for valuing big-box retail properties in the fee simple, some assessors and appraisers disagreed.

Their primary concern was that consideration of sales of vacant properties would result in lower assessed values of big-box retail properties, thereby harming the local community by depleting the tax base. The "Dark Store Theory" developed out of this concern.

The Dark Store Theory received a significant amount of press, especially in Indiana and Michigan, where the theory was spun into a populist argument against "a tax loophole," which supposedly allowed national corporations to avoid paying their fair share of taxes in local communities.

Many news sources perceived the Michigan court system's valuation of big-box properties in the fee simple as a "big discount" to corporations that was "unfair to locally-owned businesses who can't get the same discounts."[19]

Michigan Representative Steve Dianda, D-Calument, asserted that the Dark Story Theory was a loophole that rewards "companies for gaming the state's tax system" by allowing them to avoid paying "their fair share for police, fire, and the other local services they demand."[20]

As the theory received more media exposure, it also gained traction with courts in several states, including New York, Wisconsin, and Iowa.

In *Rite Aid Corporation v. Huseby*, the New York Supreme Court, Appellate Division, held that the court must apply a "recent sale of the subject property, as well as readily available comparable sales," regardless of the nature of the interests being sold.[21]

Accordingly, the court reversed a lower court's decision to reject the long-term built-to-suit lease of the subject property, as well as other built-to-suit lease transactions.[22]

Similarly, in *Bonstores Realty One, LLC v. City of Wauwatosa*, the Wisconsin Court of Appeals approved of the city appraiser's rejection of "any

conversion, redevelopment, or 'dark store' sales under the premise that those sales have a different highest and best use" than an operating store.[23]

Citing *Bonstores*, the Wisconsin District Court subsequently rejected all of the taxpayer's appraiser's vacant sales in *Target Corporation v. City of Racine*, stating that "dark stores should not be used as comparables" because "Target is not a dark store and does not share the same highest and best use as a dark or vacant store."[24]

In *Hy-Vee, Inc. v. Dallas County Board of Review*, the Iowa Court of Appeals concluded that "[i]n focusing on property that matched Hy-Vee's business [i.e., sales of operating grocery stores], the Board's expert fulfilled his obligation to classify property according to its present use and not according to its highest and best use."[25]

The Legislative "Fix"

Although courts in several states have already adopted the Dark Store Theory (to varying degrees), some states have turned to the legislature to advance the Dark Store Theory argument.

In 2015, Indiana passed two laws specifying how to value big-box retail properties which, as explained in more detail below, have already been repealed.

Indiana Code Section 6-1.1-4-43 required any big-box retail building that is 50,000 square feet or greater, occupied by the original owner or by a tenant for which the improvement was built, and has an effective age of 10 years or less, to be valued under the cost approach, less depreciation and obsolescence.

Indiana Code Section 6.1.1-4-44 limited the types of sales comparables that could be used in the assessment of commercial non-income-producing

real property, including sale-leaseback property (but excluding multi-tenant income producing shopping centers), with an effective age of 10 years or less.

Section 44 prohibited a real property sale from being used as a sales comparable if it

> (1) has been vacant for more than one (1) year as of the assessment date or in the case of industrial property vacant for more than five (5) years; (2) has significant restrictions placed on the use of the real property by a recorded covenant, restriction, easement, or other encumbrance on the use of the real property; (3) was sold and is no longer used for the purpose, or a similar purpose, for which the property was used by the original occupant or tenant; or (4) was not sold in an arm's length transaction.

The Michigan legislature also attempted to provide special requirements for valuing big-box retail properties for tax purposes. Michigan Senate Bill 524 was introduced in the Fall of 2015. If it had been enacted, Bill 524 would have amended the general Property Tax Act by requiring that the highest and best use of big box properties and other limited use properties be for the continued use of the property as improved.

This bill was intended to prohibit the consideration of vacant big box properties in establishing the taxable market value of occupied big-box properties.

A complementary bill was also introduced in the Michigan House of Representative. House Bill 4909, if enacted, would have amended the Zoning Enabling Act by preventing negative use restrictions that prohibit occupancy or use of the property, when that restriction is inconsistent with the lawful use of the property under the local zoning ordinance.

This bill was intended to prohibit the consideration of deeds frequently placed on big-box stores that restrict future use of the property in determining the true cash value of the property. Neither bill has passed.

The Constitutional Problem

The problem with the Dark Store Theory is that it is unconstitutional under most states' constitutions. The majority of state constitutions require uniformity in taxation. This is why most ad valorem property tax schemes value property in the fee simple.

Valuing property in the fee simple ensures that all property is assessed equally. Valuing property in the leased-fee, on the other hand, can lead to different assessed values for identical properties depending on who owns the properties and how they are used. The following hypothetical example illustrates this point:

Let's assume there are two identical buildings located across the street from each other. One building is vacant and the other building is leased. The value of the fee simple estates are the same. The value of the leased-fee estates, however, could vary drastically depending on whether the lease on the leased property is long or short term or is above or below market.

Valuing the two identical buildings differently would violate the uniformity clause of most state constitutions. That is why real property is most often valued in the fee simple (as if vacant and available for sale).

Based on the foregoing, Indiana Code Sections 6-1.1-4-43 and 44 could have been held to violate the uniformity clause of the Indiana State constitution. Presumably, this concern played a significant role in the recent repeal of those statutes less than one year after their adoption, on March 24, 2016. In their place, Indiana modified existing classification provisions to provide for the classification of improvements on the basis of market segmentation.

Indiana likely made this change to provide for a constitutional means of assessing occupied properties differently from vacant properties by classifying them differently, since uniformity in taxation is generally only required across the same class of property.

However, it is the authors' opinion that Indiana's new classification provisions still raise constitutional concerns regarding uniform taxation within the new class of occupied properties if it leads to the stores being valued in the leased fee.

Modifying the example above, so that the two identical buildings are both occupied, the value of their respective leased fee estates may still be significantly different based on the terms of leases in place and whether their respective rents are above or below market.

Additionally, the leased fee value of the buildings are significantly influenced by their respective occupants' creditworthiness, gross sales, and so on, thereby resulting in different property values based on who occupies the building in addition to whether the buildings are occupied at all.

The irony is that proponents of the Dark Store Theory describe it as a "discount" applicable only to large big-box retail stores; however, under most state constitutions and their corresponding ad valorem property tax regimes, a big-box store should be valued under the same real estate appraisal standards as every other type of property.

Conclusion

By manipulating real estate appraisal practices to increase the assessed values of operational stores, assessors are actually moving away from uniform taxation—the very goal they are constitutionally bound to seek.

When faced with a Dark Store Theory Argument, one solution is to identify the constitutional dilemma, to argue a return to the basics of fee simple valuation, and to value the property according to generally accepted real estate appraisal methodology.

Notes:

1. *Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: The Appraisal Institute, 2010), 79.
2. Kohl's Indiana LP v. Howard Cty. Ass'r, Nos. 34-002-10-1-4-00350 et al. (Ind. Bd. Tax Rev. Dec. 31, 2014).
3. Id. at 40 (quoting Shelby County Assessor v. CVS Pharmacy, 994 N.E.2d 350, 354 (Ind. Tax Ct. 2013) (emphasis added).
4. Id. at 43.
5. Ikea Prop. Inc. v. Twp. of Canton, No. 366639, slip op. at 34 (Mich. Tax Tribunal July 18, 2012).
6. Id. at 14-15.
7. Kohl's Dep't Stores, Inc. v. Twp. of Frenchtown, No. 369836, slip op. at 34-35 (Mich. Tax Tribunal Feb. 22, 2013).
8. Id. at 33.
9. Id. (citations and internal quotation marks omitted).
10. Kohl's Dep't Stores, Inc. v. Twp. of Kochville, No. 369840 (Mich. Tax Tribunal Feb. 22, 2013) (internal quotation marks and citations omitted).
11. Id. at 35-36 (citations and internal quotation marks omitted).
12. Lowe's Home Ctrs., Inc. v. City of Grandville, No. 317986, 2014 WL 7442250, at *6 (Mich. Ct. App. Dec. 30, 2014).
13. Lowe's Home Ctrs., Inc. v. Twp. of Marquette, No. 314111, 2014 WL 1616411, at *10 (Mich. Ct. App. Apr. 22, 2014), appeal denied, 856 N.W.2d 553 (2014), reconsideration denied, 861 N.W.2d 17 (2015).
14. Id. at *11.
15. Matter of Home Depot U.S.A. Inc. v. Assessor of the Town of Queensbury, 12 N.Y.S.3d 364, 364 (N.Y. App. Div. 2015), leave to appeal denied, 26 N.Y.3d 915 (2016).
16. Walgreen Co. v. City of Madison, 752 N.W.2d 687, 702. (Wis. 2008).
17. Id. at 703.
18. In re Equalization Appeal of Prieb Properties, L.L.C., No. 2004-3806 EQ, slip op. at XX (Kan. Bd. of Tax Appeals June 8, 2007).
19. Jake Neher, Lawmakers to make major push to end property tax discounts for big box stores, Michigan Radio (Aug. 10, 2015), http://michiganradio.org/post/lawmakers-make-major-push-end-property-tax-discounts-big-box-stores#stream/0.
20. Nick Manes, Unfair Comparisons? Meijer, other big-box retailers use 'dark store' loophole to cut their Michigan property tax bills, MiBiz (Aug. 16, 2015), http://mibiz.com/news/design-build/item/22798-unfair-comparisons-meijer,-other-big-box-retailers-use-%E2%80%98dark-store%E2%80%99-loophole-to-cut-their-michigan-property-tax-bills.
21. Rite Aid Corp. v. Huseby, 13 N.Y.S.3d 753, 757 (N.Y. App. Div. 2015).
22. Id.
23. Bonstores Realty One, LLC v. City of Wauwatosa, 839 N.W.2d 893, 902 (Wis. Ct. App. 2013).
24. Target Corp. v. City of Racine, Nos. 10 CV 1963 et al., slip op. at (Wis. Cir. Ct. Nov. 30, 2015).
25. Hy-Vee, Inc. v. Dallas, No. 13-1377, 2014 WL 4937892, at 5 (Iowa Ct. App. Oct. 1, 2014).

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