
Coates' Canons Blog: The State of the Dark Store Theory

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Consider the following scenario: Target is challenging a city's property tax valuation. The city has assessed the store at \$16.7 million, while Target contends the tax value is closer to \$8.1 million. In reaching this valuation, Target used sales comps from eight vacant big box retail establishments, and it wants the city to reduce its assessed value to reflect the market price of these unoccupied buildings. The city will lose a substantial amount of tax revenue if it accepts Target's valuation. It must choose one of two options: settle with Target or endure costly litigation.

This scenario, known as the "dark store theory," has taken center stage in numerous legal battles across the country. The key question: should fully operational big box retail stores be taxed in the same way as closed ones?

The dark store theory is a tax strategy used by big box retail stores like Lowe's, Target, Walmart, and Menards to lower their property tax value. These retailers contend that their fully operational, often thriving businesses should be assessed the same as vacant buildings or "dark stores." They claim this tax strategy is both market-based and lawful—and they've been raising these points in court.

Local governments have pushed back on this strategy because, when argued successfully, a victory for a big box retailer can mean the loss of a substantial amount of tax revenue for a county or a municipality. As a result, the local government must either shift the tax burden to its citizens and/or make cuts in local services.

The debate over valuation

To determine the true cash value of a retail establishment, a property must be assessed at its highest and best use. The three valuation methodologies that are common appraisal practices are the income approach, the sales comparison approach, and the cost approach (appraisers will often use a combination thereof). Dark store litigation arises when the parties disagree on the methodology and data to use in calculating the highest and best use of a property. For example, big box retailers are not fans of relying solely on the cost approach because this approach allegedly fails to recognize the role of functional obsolescence in reducing the value of a big box store. Instead these retailers place more emphasis on the sales comparison approach, especially when they can use dark stores as comparable properties. Municipalities reject the use of dark stores as comparables and generally give more weight to the cost approach. The outcome of a case often depends on which approach the court believes to be more accurate in calculating the highest and best use.

Who's right?

Courts have found merit on both sides of this issue. Because the use of the dark store theory first gained traction in the Midwest, in states like Michigan, Wisconsin, and Indiana, I wanted to take a closer look the judicial outcomes in these states.

Michigan

One Michigan case that recently made headlines following the state supreme court's denial of Menards' appeal is *Menard Inc. vs. City of Escanaba*, 315 Mich. App. 512 (2016), *review denied*, 501 Mich. 899, 901 N.W.2d 901 (2017). Here's a brief background: Menards appealed the City of Escanaba's tax assessments from 2012 through 2014, claiming that the true cash value of the store for each year was approximately \$3 million—not the \$7 to \$8 million that Escanaba assessed. To reach this valuation, Menards used the sales comparison approach and relied on the sales data from eight dark stores, including a former Walmart, Sam's Club, and Home Depot. The city used the cost approach to reach its valuation.

The Michigan appellate court reversed the tax tribunal's decision and ruled in Escanaba's favor. It held that Menards' reliance on the concept of functional obsolescence to discredit the cost approach was misplaced. It further ruled that the cost approach was a more reliable method of valuation given the limited or speculative comparable sales data used by Menards. "This is a most promising development," said Stephan Currie, Executive Director for the Michigan Association of Counties. Now many local governments in Michigan hope that this case has helped render the dark store tax strategy a thing of the past.

Wisconsin

Don't let the outcome of the Michigan case fool you. Many big box retailers continue to win their cases, despite a growing call for legislatures to limit or ban the use of this tax strategy. In Wisconsin, there was a recent push for legislation that would effectively overturn the Wisconsin Supreme Court's 2008 decision in *Walgreen Co. v. City of Madison*, 311 Wis. 2d 158 (2008). In *Walgreen*, the court held that the fair market value of a property subject to a lease agreement must be based on market rents rather than on the contract terms of a lease agreement on a specific property. The court reasoned that contract rents often reflected "artificially increased sales prices cause by unusual financing arrangements[.]" *Id.* The *Walgreen* decision has resulted in at least 140 assessment challenges in recent years. A bill that would have effectively reversed the *Walgreen* decision was struck down in the Wisconsin legislature in March 2018.

Indiana

Citizens in Indiana have also called for legislation to end this tax strategy. In 2015, the state passed a law that required first generation big box retail stores with an effective age of 10-years or less to be assessed under the cost approach. Retailers were also prohibited from using comparable properties that stood vacant for more than one year or that had a significant restriction placed on the use of the property. However, these provisions were repealed in 2016. The replacement legislation requires only that comparable properties be in the same market or sub-market as the current use of the subject property. See HB 1290. This new legislation has not stopped big box retailers from successfully challenging their assessed values.

Unlike in Michigan, it was the big box retailers who could cheer "victory" after the Indiana Supreme Court denied review of the first dark store theory case to reach it. *Howard Cty. Assessor v. Kohl's Indiana LP*, 57 N.E.3d 913 (Ind. T.C. 2016), review denied, 86 N.E.3d 171 (Ind. 2017). In this case, the Indiana Tax Court was persuaded that Kohl's reliance on the sales data from nine Midwestern "dark box" retail stores within the same market constituted sufficient evidence to conclude that the county had overtaxed the retailer. The state supreme court's decision not to review the county's appeal was a big blow to those who were expecting the court to seize this opportunity to shut down the dark store theory. No such luck.

Where does North Carolina stand?

It is still unclear whether dark stores can exclusively be used for valuation purposes. One recent case to touch on this issue was *Lowe's Home Centers versus the Forsyth County Board of Equalization*. *Matter of Lowe's Home Centers, LLC*, COA17-220, 2018 WL 708657 (N.C. Ct. App. Feb. 6, 2018). Lowe's challenged Forsyth County's 2013 valuation of its property located in Kernersville. The county used the cost approach to value the property at approximately \$16 million (118.69 per square foot). Lowe's used the income and sales comparison approach to value the property at approximately \$6 million (\$46.74 per square foot). The Property Tax Commission concluded that Forsyth County's reliance on the cost approach was reliable. The Commission took issue with the fact that Lowe's relied on comparable properties that were dark stores subject to deed restrictions to assess the property—and none of which were former home improvement centers.

The North Carolina Court of Appeals reversed the Commission's decision and remanded the matter for reevaluation. While the appellate court did not address whether Lowe's use of dark stores as comparable properties was appropriate, it did conclude that the county's substantial reliance on the cost approach constituted an "arbitrary and illegal" method of valuing the property. Additionally, the appellate court highlighted the fact that Lowe's evidence showed that the county's per-square-foot valuation was the highest of any Lowe's in the *United States*. Lowe's and Forsyth County recently settled for a range from \$80.34 – \$88.22 per square foot.



We must now ask whether the appellate court ruling in favor of Lowe's on the cost valuation issue will open the floodgates for additional big box appraisal appeals? It seems possible that other big box retailers that were appraised using the cost approach now have solid legal ground for a valuation appeal. In the future, tax assessors should be mindful to assess property using a combination of appraisal methodologies—and they should be prepared for retailers to continue to argue the dark store theory.

Summary

Dark store theory cases have become commonplace in tax courts across the country. In Alabama, for instance, Lowe's Home Centers has filed lawsuits seeking assessment reductions for 27 stores. Walmart, Kohls, Target and other big box stores also continue to fight for lower property taxes throughout Texas, California, Ohio, and more. However, a victory for one does not necessarily mean a victory for all. The dark store theory is not yet a widely adopted concept, and the use of traditional assessment practices may keep it at bay. I anticipate that the big box retailers, local governments, the courts, and (probably) state legislatures will continue to tackle this issue for the foreseeable future.

Links

- law.justia.com/cases/michigan/court-of-appeals-published/2016/325718.html
- wnmufm.org/post/michigan-supreme-court-rejects-dark-store-appeal#stream/0
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- docs.legis.wisconsin.gov/2017/proposals/reg/asm/bill/ab387
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