City of West Allis
Common Council
Advisory Committee Special Meeting

Discussion on Dark Store Loophole, the Walgreens Case, and Shifting the Tax Burden

July 17, 2018

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City Assessor

New Store

Empty Store

Dark Store Loophole

The **Dark Store Loophole** involves using vacant, blighted properties, in comparison to fully developed and functionally operable properties to determine fair market value.

Dark Store Loophole

So for instance, that newly constructed big box store that cost **$20 million** to build…

Walmart in Greenfield, WI

Dark Store Loophole

… is being compared to that old, vacant, run-down K-Mart built in the 70's...

Former K-Mart in Waukesha, WI

Dark Store Loophole

… and that vacant, former Lowes on Brown Deer Road.

Former Lowe's in Brown Deer, WI

Dark Store Loophole

This so called Dark Store Loophole is burdensome and harmful to Wisconsin taxpayers. It also goes against established appraisal practice.

What's considered normal appraisal practice in the financial markets is being twisted to give tax breaks to certain properties and **shift the burden** to homeowners and small business owners.

Dark Store Loophole

Market value is set by the cost of acquiring an equally desirable property

The premise of the Principle of Substitution states that a prudent purchaser will pay no more for a property than the cost of building an equivalent structure, or purchasing an existing property with similar utility or income generating capacity.

- *One of many Principles used by Assessors and Appraisers alike.*

Dark Store Loophole

In a nutshell, valuation professionals are to compare apples to apples. The Dark Store Loophole fails to follow this basic, fundamental principle of valuation.

Dark Store Loophole

This Shopko located in Neenah, WI sold for $9.6 million or $101 per square foot. It is a fully functional “big box” store.

Dark Store Loophole

In 2017 when Walmart went before our Board of Review they claimed Sam's Club, assessed at $11 million, was only worth $7.2 million or $55 per square foot. Almost half that of the Shopko in Neenah.

Dark Store Loophole

Their tax representative who filed the assessment appeal provided documentation stating that this vacant, former Lowe’s located in Elgin, IL was equivalent to Sam’s Club. This Lowes sold for $5.3 million.

Dark Store Loophole

In 2018 Walmart filed a second appeal requesting an even lower value of $4.8 million or $37 per square foot.

Dark Store Loophole

In 2015 Target secured a $900k reduction in assessed value using the Dark Store Loophole. This property is currently assessed at $9.2 million.

Dark Store Loophole

In 2017 Menard's appealed at the Board of Review requesting a $1.9 million reduction using the Dark Store Loophole. This property is currently assessed at $3.75 million.

Dark Store Loophole

In 2017 even a small office building owner appealed at Board of Review requesting a $700k reduction. This owner's tax rep utilized the Dark Store Loophole for an office building!

The Walgreens Case

Damaging Effects of the Walgreens Case

In 2008 the Wisconsin Supreme Court held in *Walgreens v. City of Madison* that an assessment using the income approach of commercial property leased at "above market" rents must be based on hypothetical "market rents" rather than the terms of Walgreen's actual leases and that the value added by an "above-market" rent constitutes a contract right, rather than a real property right.

The 2008 decision requires assessors to value Walgreens and other leased commercial and manufacturing properties substantially below the property's actual recent sale price.

Damaging Effects of the Walgreens Case

Things may get dry for a moment…

Damaging Effects of the Walgreens Case

This idea of **"above market"** rent is disingenuous for several reasons.

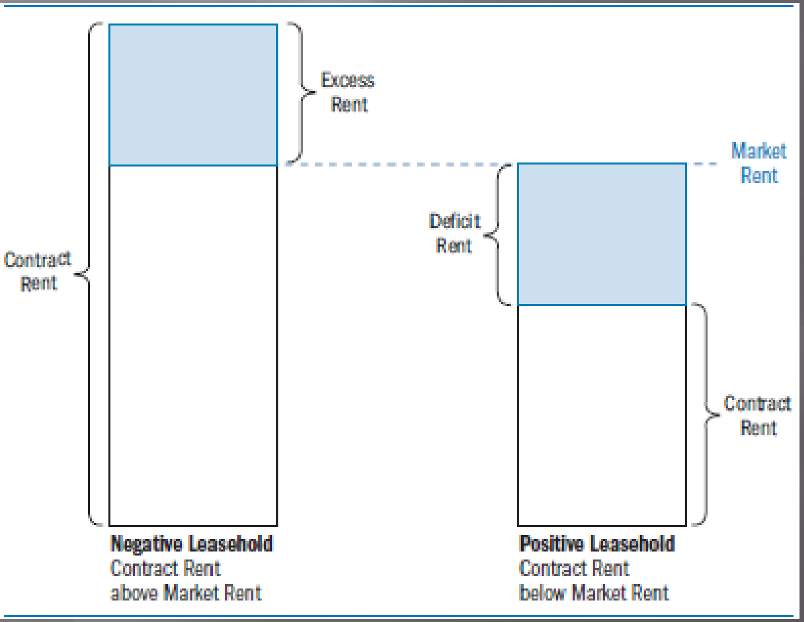
The real estate market sets market rents. These Walgreens leases were established in a competitive market and therefore represent market rent.

- Types of ownership structures
  - Corporate owned – corporate entity owns land, building, and business
  - Ground leases – land is leased to owner of building/business
  - Sale Lease-back – owner sells the real property, then leases is back from the buyer.
- These transactions occur in a competitive market between land owners, real estate developers, investors, and business interests (tenants).
  - An example would be prime corner lots at busy intersections – Ray Kroc
  - In the past Trader's Joes sought out sub-prime locations to save on real estate costs.
  - Joe's Chicken Shack vs. Big National Chain
- Cost to acquire and build must be covered by the rents obtained from the lessee.
- The Walgreens decision ignores the fundamentals of supply and demand and competition in the market place.

Damaging Effects of the Walgreens Case

Businesses and investors do not overpay "above market" rent to secure a location or a particular ground lease, they compete in the market with other potential investors. Instances of "above market" rent or "below market" rent is indicative of effects on fluctuating markets relative to contract rent.

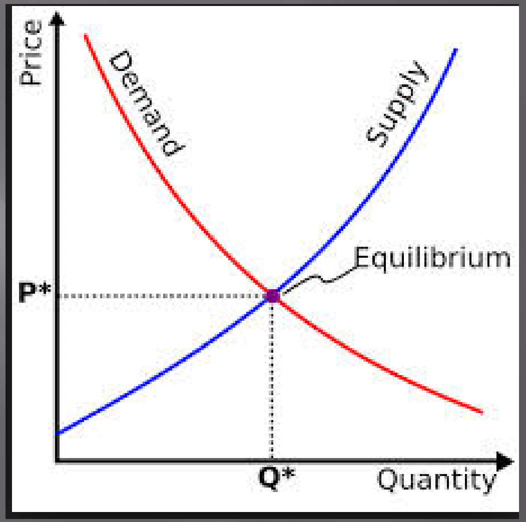
- Shifts in supply and demand cause prices to increase or decrease. As a result, a single property may have different values over time and are described as negative or positive leasehold interest.



Source: The Appraisal of Real Estate, 14th Edition

Damaging Effects of the Walgreens Case

Real estate users compete in the market place for locations that fit their business needs. Price and contract rent is determined by supply and demand and competition in the market.



These leases represent market rent for real estate transactions – the revenue, expenses and income are all tied to real estate fundamentals and do not consider the going concern, business value, or intangible value.

Damaging Effects of the Walgreens Case

*"…90 percent of stock market volume is done by institutions, and half of that is done by the world's 50 largest investment firms, deeply committed, vastly well prepared--the smartest sons of b*****s in the world working their tails off all day long…"*

- Winning the Loser's Game by Charles D. Ellis

Damaging Effects of the Walgreens Case

To paraphrase Mr. Ellis, corporations and their teams of accountants, attorneys, appraisers, and real estate professionals are deeply committed, vastly well prepared, smart people working their tails off all day long to make sure that leases are set at market rent, values are fair, and ultimately the return on investment is advantageous to them.

Damaging Effects of the Walgreens Case

So the notion of overpaying "above market" rent misses the mark. In practice these actual leases represent market rent. Businesses are not in the business to lose money or overpay above market rent. The values derived from these market based leases undergo an overwhelming amount of scrutiny by professionals to ensure a return on investment and establish **true values**.

Damaging Effects of the Walgreens Case

So then it may come as a surprise that true values used for Federal income **tax reporting, lending purposes**, and **purchase or sale transactions** are **not** the same for **tax assessment** purposes.

Damaging Effects of the Walgreens Case

There are four Walgreens and two CVS pharmacies in West Allis. Following the Walgreens Supreme Court case all four Walgreens sought and received reduced assessments. Today, those Walgreens are collectively assessed at $7.8 million or an average of $1.95 million each.

Damaging Effects of the Walgreens Case

Since then, the Walgreens located at 10725 W. Greenfield sold for $4.5 million. This property is assessed at $1.78 million.

Damaging Effects of the Walgreens Case

The Walgreens located at 6101 W. Greenfield was listed for sale at $5.15 million and recently sold this past March for $4.9 million. This property is assessed at $2.5 million.

Damaging Effects of the Walgreens Case

Moreover, Walgreens typically sell for around $5 million or more in Wisconsin. For the four Walgreens located in West Allis that suggests a total fair market value of $20 million or more. Yet, we are forced to assess them at less than $8 million collectively.

That's more than $12 million lost and the tax burden shifted to homeowners and small business owners.

Damaging Effects of the Walgreens Case

Sales and pending sales of Walgreens and CVS stores

Location	State	Transaction Date	Year Built	Transaction Price	Cap Rate	Project Size	Price Per SF
Sailsbury	Maryland	Under Contract	2012	$6,000,000	6.35%	14,739	$407
Peoria	Illinois	Under Contract	2012	$4,100,000	6.40%	14,820	$277
Biloxi	Mississippi	Under Contract	2007	$5,045,000	6.25%	14,550	$347
Memphis	Tennessee	10/1/2012	2003	$4,029,629	6.75%	14,092	$286
Kankakee	Illinois	8/6/2012	2009	$6,756,000	6.35%	14,820	$456
Mount Juliet	Tennessee	5/29/2012	2007	$5,150,000	7.28%	14,820	$348
Bel Air	Maryland	5/24/2012	2011	$7,500,000	6.33%	14,550	$515
Steubrenville	Ohio	5/24/2012	2010	$4,550,098	6.40%	13,650	$333
Greenwood	South Carolina	5/4/2012	2007	$5,130,000	6.88%	14,484	$354
Chamberburg	Pennsylvania	4/19/2012	2008	$6,666,667	6.50%	14,764	$452
Greenwood	Arizona	4/12/2012	2009	$4,846,700	6.85%	13,650	$355
High Point	North Carolina	2/23/2012	2011	$6,636,500	6.50%	14,490	$458
Port St Lucie	Florida	2/23/2012	2009	$7,775,000	6.53%	14,820	$525
Spring Hill	Tennessee	2/13/2012	2008	$5,100,000	6.62%	14,820	$344
Litchfield	Illinois	2/15/2012	2007	$4,360,000	6.88%	14,820	$294
Orlando	Florida	2/6/2012	2010	$10,030,000	6.50%	14,490	$692
Marco Island	Florida	1/11/2012	2000	$5,700,000	7.10%	15,861	$359
Venice	Florida	12/21/2011	2009	$9,300,000	6.50%	14,820	$628
Plantation	Florida	11/30/2011	2006	$6,201,550	6.45%	12,863	$482
Kimarnok	Virgina	10/31/2011	2008	$5,000,000	7.00%	14,820	$337
Buckeye	Arizona	10/4/2011	2009	$5,050,000	6.80%	14,820	$341
Average:				$6,267,511	6.88%	14,482	$440

Source: Colliers

Summary

The Dark Store Loophole and the Walgreens case are a practice of trickery and deception. It twists established appraisal practice to give tax breaks to certain properties, ignores legal precedent, eschews fundamental appraisal practices and market realities, and ultimately shifts the tax burden to homeowners, renters, and small businesses.

Shifting of the Tax Burden

Shifting of the Tax Burden

So how does this shift of the tax burden happen?

Shifting of the Tax Burden

Let's say the *Village of Honey Creek* has four properties. Each of these properties are valued at $250,000 each for a total value of $1,000,000. Notice that each property's value equals exactly 25% of the total value, i.e., ($250,000/$1,000,000 = 25%)

Property #1	$250,000	25%
Property #2	$250,000	25%
Property #3	$250,000	25%
Property #4	$250,000	25%
Total Value	**$1,000,000**	**100%**

Shifting of the Tax Burden

The *Village of Honey Creek* has a tax levy of $25,000, which equates to a mill rate of $25 per $1,000 of value or a 2.5% tax rate, i.e., ($1,000,000 / $25,000 = 2.5% x 1,000 = 25.00)

In a Fair & Equitable property tax system this $25,000 tax burden would be shared by these properties in an equal distribution.

▫	Property #1	($250,000 / $1,000) x 25.00 = $6,250
▫	Property #2	($250,000 / $1,000) x 25.00 = $6,250
▫	Property #3	($250,000 / $1,000) x 25.00 = $6,250
▫	Property #4	($250,000 / $1,000) x 25.00 = $6,250

▫ **Total Tax Burden** **$1,000,000** **$25,000**

Shifting of the Tax Burden

Now let's say the owner of Property #2 uses the Dark Store Loophole and successfully appeals the assessed value and it is now "worth" half of what it was before.

You'll notice that a few things happen: the total value of the *Village of Honey Creek* drops to $875,000 and the percent share of value of each property changes.

Property #1	$250,000	28.6%
Property #2	$125,000	14.2%
Property #3	$250,000	28.6%
Property #4	$250,000	28.6%
Total Value	**$875,000**	**100%**

Shifting of the Tax Burden

In this case, the **tax burden** for the *Village of Honey Creek* remains constant at $25,000, but now the new mill rate is $28.60 per $1,000 of value, or 2.86% tax rate, i.e., ($25,000 / $875,000 = 2.86% x 1,000 = 28.60)

Property #1	($250,000 / $1,000) x 28.60 = $7,150
Property #2	($125,000 / $1,000) x 28.60 = $3,550
Property #3	($250,000 / $1,000) x 28.60 = $7,150
Property #4	($250,000 / $1,000) x 28.60 = $7,150
Total Value	**$875,000** **$25,000**

Shifting of the Tax Burden

"The Waterbed Effect"

Pushing down on one spot causes other areas to rise. The amount of water in the bed stays the same, it's just shifted someplace else. Relative to our example, the tax levy remained the same but the tax burden was shifted to other property owners.

Shifting of the Tax Burden

- In this hypothetical scenario the total value of properties dropped and the mill rate increased from 25.00 to 28.60, while maintaining the tax levy at $25,000.
- While Property #2 enjoys a 9.2% reduction in its tax bill, it does so at the expense of other property owners.
- The other properties saw a 14.4% increase in their tax bill amount, yet the levy and their property value stayed the same.

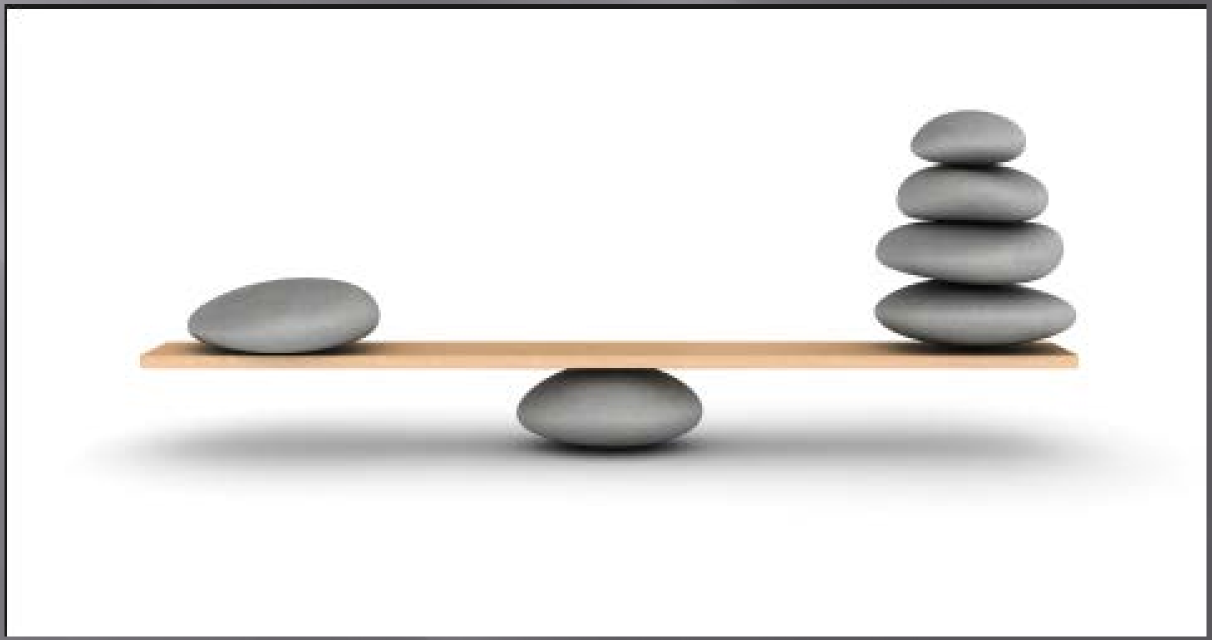
Shifting of the Tax Burden

In these cases, in order to **maintain a tax rate,** or if a municipality **does not have the ability to raise the tax levy,** the result is downward pressure on the levy and cuts must be made to services.

Shifting of the Tax Burden

So the Dark Store Loophole and Walgreens Case forces either a **shift of the tax burden** or **cuts to municipal services**.

In any case the rest of the tax payers are **bearing the burden** in a disproportionate manner.



In Practice

- This was a simplified example to drive home the point that the Dark Store Loophole is detrimental and must be stopped.
- In practice things are much more complicated with many moving parts. The tax rate, levy, and assessed values change from year-to-year. Things are further complicated with the levies of other taxing jurisdictions, assessment levels of other communities, State mandates on levy limits, etc.
- “What If?” scenarios can be endless. What if the levy stays the same, but values change? What if the levy decreases, but values increase, etc.
- Generally speaking, during times when values are increasing, the damaging effect of the Dark Store Loophole *may* go undetected. But in other times, the effects may be crushing.
- Closing comments: *Ordo Ab Chao, Occam's Razor, and Standing at the Counter*

Wrapping Up…

K-Mart Redux

Remember that old K-Mart in Waukesha?

K-Mart Redux

An investor bought it for redevelopment at a cost of $2 million…

K-Mart Redux

…and after spending $2 million more on renovation to make it usable it is now a thriving, functioning building, just like all those other thriving, functioning buildings trying to use the Dark Store Loophole.

Lowe's Redux

And remember that old Lowe's on Brown Deer Road?

Lowe's Redux

Walmart bought this "dark store" for $4,000,000 then invested an additional $6,415,000 to renovate the building to function as a Walmart. Total cost to create an equivalent structure was **$10,415,000** or $75 per square foot.

Fair & Equitable

Remember…

The premise of the Principle of Substitution states that a prudent purchaser will pay no more for a property than the cost of building an equivalent structure, or purchasing an existing property with similar utility.

This is NOT Fair & Equitable

This is Fair & Equitable!

What Can You Do?

Next Steps

There is an advisory referendum on the **August 14** partisan primary ballot, which means **voters will get the opportunity to make their views known** on this important issue.