DRAFT Big Box Position Paper

I. PURPOSE

This position paper provides information and guidance for the application of the three approaches to value for commercial big-box retail. Some jurisdictions require consideration of all three approaches while others require one approach specifically or take a tiered process with one approach preferred over another approach. The paper provides aid regardless of the specific methodologies required by a jurisdiction.

The scope of the paper is limited to big-box retail stores from 50,000 square feet to 200,000+ square feet in size; however, it is acknowledged that the market trend for box retail is shifting to both smaller and larger stores. For example, one major retailer has six different prototype stores that vary from 15,000 square feet to 260,000 square feet depending on trade area characteristics. The discussion in the paper may be applied to any size retail store and also to other property types.

II. SUMMARY OF BIG-BOX ISSUES

During the research process for the paper, several issues were identified as repeatedly arising in the appeal of big-box retail ad valorem valuations. What follows is a brief synopsis of the significant issues addressed in the paper from the perspective of big-box users:

- Dark Store Theory - big-box stores should be valued as-if-vacant and available rather than as a functioning, operating store.
- Fee simple mandates real property be valued as-if-vacant, owner-occupied, or unencumbered by a lease, so only vacant, or soon-to-be vacant stores can be used as comparable sales properties in the Sale Comparison Approach to Value. An income approach is not applicable.
- Only comparable leases of second-generation space can be used to estimate market rent in the Income Capitalization Approach. Sale-leaseback transactions and build-to-suit properties should be disqualified, as the assertions made are that these transactions are either based on financing or on costs of customized improvements.
- Tenant Improvements –no other big-box user wants a store designed for another big-box user. As soon as a store is built it has functional obsolescence, usually in the form of a super adequacy.
- Tax assessments are based on value-in-use and not on market value. The property’s value is only worth something to the current user, which often times is the retailer that built the property.
• No other big-box user wants a store designed for another use, but big-box retailers still frequently deed restrict abandoned stores to prevent a similar or other big-box user from using the improvements in a competing capacity.

• Existence of abandoned big-boxes, regardless of self-imposed deed restrictions, is cited as evidence of functional obsolescence of occupied and operating properties.

• Big box retailers and representatives for big box users identify other generic properties that are big boxes for use as comparison with their property. It is the assessors who claim these properties often have a dissimilar highest and best use and should not be used for comparison.

**III. DARK STORE THEORY**

Dark store theory asserts that fully occupied, functional and well maintained big-box properties built to suit the original occupant (first-generation user) should be valued “as-if-vacant and available” for a fee simple absolute valuation to reflect many retailers’ view of the meaning of fee simple absolute. The concept of as-if-vacant has been tried for corporate headquarters, warehouse distribution centers, malls and shopping centers without much success.

The theory’s premise is that big-box retailers occupy specially designed and constructed improvements built to suit a specific retailer’s needs; thereby, on the date the store opens, it is inherently functionally obsolete because of one or more reasons, such as super adequacy (ex. size) and specialized tenant improvements (façade, signage, and the color). Because the properties are not built with re-sale or leasing in mind, the functional obsolescence limits the market to buyers/users in the second-generation market. It is assumed that these second-generation users will not want the improvements for the original intended use but for a different use i.e. the property has a highest and best different than the current use.

Consequently, the retailers argue that the selection of comparable properties should be based on the hypothetical that the current user vacates and the property is “vacant and available;” thus, the comparable sales should be sales of vacant big-box stores and comparable rents should be second-generation rents from the local market; otherwise, the value is not a fair market value but value-in-use to the current user. “Dark store” is not a defined appraisal term, and it actually means as-if-vacant; thus, dark store will not be referenced in the remainder of the paper.

**IV. REAL PROPERTY RIGHTS IN REAL ESTATE**

*Ad valorem* tax valuation is a legal construct. The specific laws, regulations and case law of a jurisdiction control what is valued and how it is valued. This is why there is a jurisdictional exception in the *Uniform Standards of Accepted Appraisal Practice*. Because it is a legal construct, interpretation of the law and regulations are controlled by legal analysis not an appraisal analysis; thus, what is required by a jurisdiction for *ad valorem* valuation may not be consistent with appraisal theory and/or practice.
The appraiser must know exactly what a jurisdiction means by fee simple estate by how the jurisdiction defines “real estate,” “real property” and/or “land” and this requires the ability to differentiate among estates in land, real property rights, including fee simple and leasehold.

A. Fee Simple Valuation for Ad Valorem Taxation

The definition of fee simple estate quoted by appraisers and written into the Appraisal of Real Estate, supra, p. 5 and in The Dictionary of Real Estate Appraisal, 6th ed., Appraisal Institute, (2015), p 90 is in part a definition:

Absolute ownership unencumbered by any other interest or estate . . .

and the remainder is not a definition but are examples as to how a fee simple estate may be infringed on by an act of government i.e. without the voluntary consent of the owner of the fee simple estate:

subject only to the limitations imposed by the government powers of taxation (tax lien foreclosure); eminent domain (a taking under due process of law for a governmental purpose, e.g., roadways or for use by a non-governmental entity in the interest of the health, safety, and welfare of the populace as a whole, e.g., revitalization projects); police power (regulatory for the protection of the health, safety, and welfare of the populace in generation, e.g., building and zoning codes, taking without prior due process of law during a declared emergency or by operation of a law such as confiscation of ill-gotten gains arising out of a crime), or by escheat (death of owner without a will and without heirs, the real estate reverts to the state).

According to Black’s Law Dictionary, 10th Edition, the term “fee simple” dates back to the 15th Century where the term was understood to mean “The estate in fee simple is the largest estate known to the law, ownership of such an estate being the nearest approach to ownership of the land itself which is consonant with the feudal principle of tenure. It is ‘the most comprehensive estate in land which the law recognizes’; it is the ‘most extensive in quantum, and the most absolute in respect to the rights which it confers, of all estates known to the law.’ Traditionally, the fee simple has two distinguishing features: first, the owner (‘tenant’ in fee simple) has the power to dispose of the fee simple, either inter vivos or by will; second on intestacy the fee simple descends, in the absence of lineal heirs, to collateral heirs – to a brother, for example, if there is no issue.” Peter Butt, Land Law 35 (2d ed. 1988).”

Today, the current legal definition is defined as “An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs; esp., a fee simple absolute.- Often shortened to fee.”

Some appraisers misconstrue fee simple to mean as if unencumbered by a lease or as if vacant. For purposes of ad valorem valuation, the appraiser must know what is to be valued as defined by law. An ad valorem valuation should be based on the law within that jurisdiction.
The term “leased fee” is an appraisal term, it is not a legal term and it is rarely used by market participants in the sale transaction market. Leasehold is a legally-defined term as well as an appraisal term. The terms are used in the following context in *ad valorem* appraisal.

- Leased fee value – this is simply the value of the fee simple interest in the property subject to a lease. If the lease is at market rent, then the leased fee value and the fee simple value are equal. However, if the tenant pays more or less than market, the value of the leased fee estate may be more or less than the fee simple value.

- Leasehold value – the interest held by a tenant. If the tenant pays market rent, then the leasehold has no market value. However, if the tenant pays less than market, the difference between the present value of what is paid and the present value of market rents would be a positive leasehold value in the real estate for the tenant.

**B. Possessory Rights (Leasehold)**

A lease creates no ownership interest in real property. Because no ownership interest in real property is created by a lease, the fee simple estate is not affected, but the value of real property may be affected positively, negatively, or not at all.

A lease creates a leasehold estate that is a right to occupy, which is a possessory interest but not an ownership interest. The fee owner can sell the fee simple in the real estate subject to the lease and without permission of the lessee. Generally, the lease must be honored by the new owner, although may be written to terminate on sale. Under foreclosure, leases can be terminated, and in cases of tax foreclosures they automatically terminate.

In summary:

- A lease is not a lien against real estate. A tenant cannot foreclose against the real estate if the lease agreement is breached by the landlord. A breach of the lease is controlled by contract law.

- A tenant cannot sell the real property.

- A tenant cannot mortgage the real property.

- A tenant cannot sublease its leasehold estate without permission of the landlord.

- A tenant cannot mortgage its leasehold estate without permission of the landlord. If allowed, the rights of the tenant’s lender are subordinate to the landlord’s rights. Without a subordination, non-disturbance and attornment agreement, the rights of the tenant and the tenant’s lender can be terminated on foreclosure by the landlord’s lender.

- A tenant cannot improve the real property without permission of the landlord and the improvements belong to the landlord on the termination of the lease or the tenant must return the real property to its original state.
If a jurisdiction requires the valuation of the fee simple estate it likely means that all of the property rights are to be valued and the value of the property rights are charged back to the owner of the fee estate for the assessment of taxes. A property right can have value regardless of who has an interest in the property right. It is the market value of the property rights that is to be valued not interests or estates in the real property.

As a leased property is held in fee simple, a property that sells subject to a lease can be used to value the fee simple property rights. It can be used as a comparable for a subject property that is leased or owner occupied. All that is required is to ensure the income stream of the sale comparable property reflected a market net operating income and if not, the sale price needs to be adjusted accordingly. In a similar manner, if the terms of the lease reveal that the rent is above or below what is considered to be at or close to market levels, an adjustment to the rent may be made for excess or deficit rent.

A leased vacant comparable property may or may not reflect the fee simple property rights. The property may be vacant because it is deed restricted thereby limiting its use. If the deed restriction keeps the vacant property from being used for the same highest and best use as the subject property, it should not be used as a comparable.

V. DEFINITIONS OF VALUE

A. As-Is Market Value

Most jurisdictions require a market value estimate. Usually the jurisdiction will define market value in a statute and will constitute a willing seller and a willing buyer acting in full knowledge without duress in an open market, arm’s length transaction. Generally, the market value will be the “as-is” market value absent direction to use of a hypothetical condition by statute because real property transfers in its as-is condition. The Dictionary of Real Estate Appraisal, supra, p. 13 defines as-is market value as:

The estimate of the market value of real property in its current physical condition, use and zoning as of the appraisal date.

B. Other Market Value Terms

A jurisdiction may also use the term market value, fair market value, cash value or true cash value, among others. An appraiser should identify the applicable value as it is defined by the jurisdiction and carefully follow that definition, especially if it requires the as is condition, an open market, arm’s length transaction in cash and between unrelated parties. Other value related terms, such as value-in-use and use value, may apply in some jurisdictions. If so, these should be carefully scrutinized also for possible application in assessment valuations.
VI. THE HYPOTHETICAL SALE

The *ad valorem* value is usually to be as of a certain date based on a hypothetical sale. Unless a jurisdiction specifically requires otherwise, by definition, the hypothetical sale is a given; thus, it is assumed that for ad valorem tax purposes there is a market for the subject. The assessor is not required to prove the existence of a market; however, exposure time on the market may affect value when demand is limited or when there is no active market because supply is scarce. Big box retailers often restrict the supply available in the market by the use of deed restrictions that prohibit the original intended use of the subject property. It can be concluded that the value of the property is diminished when these limitations are imposed on the property and that the pool of potential buyers also will be reduced as a result.

A. Hypothetical Seller

Among important facts to consider with a hypothetical seller are the reasons or motivations for selling a property. Is the property selling because it has functional obsolescence or is there a lack of market demand that is causing the property to underperform? These are factors that an assessor may want to consider in the property valuation. For example, sometimes the motives for selling have more to do with a retailer’s corporate decision to downsize or move to a different side of the street that has better traffic flow. The store may be fully functional with no obvious, identifiable issues that would render the property unmarketable. It is for the appraiser to determine marketability, functional obsolescence factors, and other variables that may potentially impact the motives of the seller.

B. Hypothetical Buyer

As there is a hypothetical sale and seller, there is also a hypothetical buyer. A prospective buyer of a property may consider a functional property that was occupied and operating successfully in a location as validation that the location is viable for their business. The fact that another similar property was successful in that particular location or on a nearby site may be evidence that there is potential success and market demand. The hypothetical buyer should not be eliminated from the universal pool of prospective buyers.

VII. TENANT IMPROVEMENTS

In build-to-suit construction, the developer may or may not provide trade fixtures, other personal property, and inventory as part of the construction contract. Often these agreements are for the construction of real estate improvements only. This issue can be researched and resolved through the verification of the comparable rentals and review of actual subject property construction cost documents. Trade fixtures are items of personal property that usually may be removed from the structure without material damage. For example, coolers and freezers may or may not be attached to the real estate and may or may not be considered a cost item in replacement cost new.

Some argue that specialized retail construction (recognizable features associated with a particular retailer) has no market value but only value to the current user; and thus, the contract rents paid
are above market rents. A close analysis of this assertion suggests that is not always borne out by the facts. On balance, for big-box properties, the interior is a vast space that any number of similar users can put to use if it is not deed restricted.

Most big-box tenants require some type of tenant improvement specific to their needs. The market determines what, if any, tenant improvements are financed by the owner and what are paid for by the tenant directly. How the market typically handles tenant improvements should be ascertained in the comparable lease properties selected. Consequently, adjustments may or may not be necessary to the estimated market rent used for the development of the income stream to be capitalized. The adjustments should be consistent with market behavior.

Signage in the interior is personal property and is usually provided by the retailer as part of their trade fixtures. The signage is usually minimal and easily removed without significant damage to the underlying real estate. Typical interior branding that is attached to the interior of the improvement is the paint on the walls and perhaps the color or type of flooring. As all big-box improvements require these types of interior improvements, the cost for these improvements will be relatively the same regardless of the retail user. If such improvements would be removed by a lessee and reflected in the market rent estimate, the removal costs can be adjusted in all approaches to value.

Tenant improvements such as signage on the exterior may be considered personal property and could be handled one of three ways: 1) the developer pays for the sign and installs it so it is included in the construction agreement; 2) the owner/user pays for the signage and the developer installs it so only labor and equipment is included in the construction agreement or 3) the owner/user pays directly to the company that makes the sign for the cost of the sign and the installation. Again, what is typical in the market will be reflected in the market rent development and adjustment to the approaches to value may or may not be necessary. Further, the costs for the exterior signage is typically inconsequential to the overall improvement value. The signage may be easily removed and replaced and any cost associated with its removal can be deducted from the value conclusion.

All real property has a façade. The façade uniqueness is often overstated by the big-box retailer. Local zoning laws have very specific requirements for exterior construction materials, landscaping, size of improvements, size, height, type and placement of signs, setbacks, parking requirements, exterior lighting, water retention and runoff requirements, colors, building height, etc. While every retailer has a prototype, it is just that, a prototype. Every big-box prototype is adjusted to meet the site size and the zoning requirements of the locality. Good evidence that the exterior façade is not unique is that existing retailers frequently update exteriors to a new, modern appearance. For example, in the fast food industry McDonald’s, among others, has done a face lift of many of its restaurants.

Some modification and level of customization are expected when a new tenant takes over a space. This does not make the property functionally obsolete. Consider this, if a big-box has no utility to any similar user, why are deed restrictions placed on the property? The actual actions of the retailers belie the argument that big-box retail is functionally obsolete the day it opens for business. The deed restrictions are put in place because one big-box user may use another big-
box user’s store. The deed restrictions are intended to limit competition by forcing a change in highest and best use from a first-generation use to a second-generation use.

VIII. SALE TRANSACTIONS

Some appraisers reject a comparable sale as a valid, open market transaction if the property exchanged is a build-to-suit property, a sale-leaseback transaction or a private sale.

For big-box users and single retail property users overall, the current practice for financing construction of a new improvement is through build-to-suit arrangements. This arrangement is as common, if not more so, than traditional mortgage financing. The developer obtains the financing to build the improvements for the user and the user opts to make lease payments instead of mortgage payments to a bank.

The elimination of build-to-suit rents, the sale of a property with a build-to-suit lease, a sale leaseback, and private sales should not be automatic. Unless there is evidence to the contrary that is inconsistent with the applicable market value definition, sale transactions of these types of transactions may be used as comparable sales. It is up to the appraiser to verify the transaction details.

A. BUILD-TO-SUIT

ABC Retail wishes to enter a new market location as part of its overall plans for expansion. ABC Retail is a creditworthy, regional player in its retail segment and has been making strides to move nationwide. ABC Retail makes a business decision that the best way for it to continue a steady expansion is to not finance the new development with its own capital for which it has sufficient funds available and to forego traditional lender financing. ABC Retail wants to keep sufficient liquid funds available to cover personal property and inventory acquisitions for new locations and to continue its steady expansion plans that include the possibility of acquisitions or mergers.

ABC Retail sends invitations to bid to various developers and negotiates with Developer Jones to purchase the land and build the improvements as ABC Retail specifies and on completion, ABC Retail will lease the property from Developer Jones. Developer Jones obtains mortgage financing for the development. The lease rate is based on a negotiated rate to cover all of Developer Jones’ soft and hard costs for the development (return of capital) and to provide Developer Jones with a profit margin (return on capital).

On the reverse side, ABC Retail knows what its cost of capital for mortgage financing would be if it wanted to own the subject. ABC Retail also knows its cost of capital for financing the purchase of personal property and inventory. It also has calculated its expected sales at the new location and its associated costs of owning the subject as opposed to leasing the subject. In the negotiation of the lease rate, it too has negotiated a rent that when amortized over the life of the lease term will be comparable to its cost of capital through other financing mechanisms.
ABC Retail and Developer Jones are not related parties. Both are knowledgeable, sophisticated parties. Neither party is forced into this arrangement. Both parties act in their own self-interest. Either party can walk away if the arrangement is not mutually beneficial. Developer Jones will not undertake a project that he does not think will be profitable. ABC Retail will not use Developer Jones if it cannot get what it needs for no more than its costs of capital from another developer or other sources. This build-to-suit arrangement, when both parties agree that the rental reflects market rent, is an open market transaction and may be used as a comparable sale.

**B. SALE LEASEBACKS**

Now consider the same facts as above but instead of a build-to-suit, ABC Retail finances the project with its own capital or by mortgage financing as it allows for faster development than a build-to-suit plan. While the project is in development, ABC Retail markets the property on the NNN lease market through a broker and negotiates with NNN Investments to purchase the subject on completion from ABC Retail and ABC Retail will lease the subject back from NNN Investments. Subject to verification, the purchase price and the rental rate is usually set at market as agreed to by the parties.

ABC Retail and NNN Investments are not related third parties. ABC Retail and NNN Investments are fully knowledgeable and sophisticated parties who negotiate an agreement that meets NNN Investments required return on its purchase price and ABC Retail has negotiated an agreement with NNN Investments for a market rental rate. ABC Retail is not paying more nor paying less than what it would pay in rent through a direct lease with a developer. NNN Investments is not engaged in usury nor has it colluded with ABC Retail so that ABC Retail receives more benefit than it would have received by any other store development arrangement. Subject to verification of the above facts, this is an open market transaction.

**C. PRIVATE SALES**

Now consider both scenarios in which Developer Jones or NNN Investors puts the subject on the market and sells the subject to Retirement Fund subject to ABC Retail’s leasehold. The transaction is not between related parties. All parties are knowledgeable acting in their own self-interest and without duress. ABC Retail’s prior business relationships with Developer Jones or NNN Investments are not relevant. This transaction is not a build-to-suit or a sale-leaseback transaction. This is an open market transaction.

Given the uniqueness, size and location of the property, the broker knows that there is a specific group of market participants who would be interested in the subject and have the financial capabilities to transact the purchase. The broker specifically solicits this group. One of the group buys the property. This may be termed a private sale but it is a valid market transaction. None of the parties is related. No one was under duress. All parties acted in their own self-interest. The broker used segmentation marketing to target potential market participants that the broker knew were the most likely buyers rather than market a vast number of buyers who have no real possibility of purchasing the subject. This is an open arm’s length transaction.

**IX. HIGHEST AND BEST USE**
Highest and best use is a theoretical concept that underlies valuation analysis. An appraiser must first perform general market analysis in order to then analyze the characteristics of the market that cause the subject property to have value...Highest and best use is the use that generates the highest net return to the property over a reasonable period of time. (Property Assessment Valuation, 3rd ed., IAAO)

The highest and best use of the land as-if-vacant and available for use may be the same as the existing use or differ from the highest and best use as improved. It will be different when existing improvements are either an interim use or are approaching the end of their economic life but still contribute value to the real property in excess of the value of the land. If the subject property is a vacant big-box store, the highest and best use of the property may be determined by analyzing sales of similar vacant stores and appropriate land sales to establish whether the property’s improvements have reached the end of their economic life. If the subject property is operating successfully, the current highest and best use is often considered to be the current use.

The process of determining highest and best use as-if-vacant and as improved requires analysis of four elements that should be done in the order as listed below:

A. As-if-vacant

1. Legally Permissible

Legal limitations such as zoning regulations or deed conditions and restrictions impact development potential. If a use is prohibited by government or by private covenants (deeds, plats, developer’s agreements, executory statements), the use is immediately excluded as a potential highest and best use. When the first-generation big-box owner/user vacates, it frequently places restrictions in the deed to prohibit competition, which sometimes leads appraisers to conclude incorrectly that a the big-box is now a second-generation store incapable of commanding first-generation rents when it is the restriction, not the design of the building or changing trade area trends that limits the potential use of the building to a second-generation use. For this reason, it is imperative that an appraiser research and consider the specific reasons why the prior retailer vacated the property. By way of example, the following is an example of such a restriction:

TO HAVE AND TO HOLD said Land unto Grantee, and its successors and assigns, forever, with all tenements, appurtenances and hereditaments thereunto belonging, subject to easements and other matters of record, and subject to the following restrictions: For a period of TWENTY-FIVE (25) years from the date hereof, said Land may not be used as a discount department store whose overall retail concept is based on a discounting price structure, a wholesale membership club or warehouse store, a grocery or supermarket or similar type store, or a pharmacy (collectively, the "Use Restrictions"). Those portions of the building leased to (intentionally omitted for confidentiality) (collectively, the "Leases") shall be exempt from the Use Restrictions for those periods the Leases shall be in effect, however, in no instance shall the exemption for the building area leased by (ABC retailer) last beyond May 31, 2018. The aforesaid restrictions shall run with and bind said
Land and shall inure to the benefit of and be enforceable by Grantor or an affiliated company or its successors, by any appropriate proceedings at law or in equity to prevent violations of such conditions and restriction and/or to recover damages for such violations from the then current owner of the Land. However, such conditions and restrictions shall remain in effect for Twenty-Five (25) years from the date hereof.

And said Grantor does hereby warrant the title to said Land, and will defend the same against the lawful claims of all persons claiming by, through and under Grantor, but none other, subject to the easements, encumbrances, restrictions, and other matters of record and the restrictions as stated herein in Exhibit "B" hereto and incorporated herein.

2. Physically Possible

Factors such as site size, shape, frontage, topography, soil composition, flood zone and access to utilities may limit use. A use may be legally permissible but if the physical characteristics of the land support the use. Thus, the proposed property may not be a viable option on the site.

3. Financially Feasible

The determination if a use is financially feasible is largely dependent on supply and demand for the legally permitted and physically possible uses and the costs associated with development. Recent construction of other big-box properties in the market may be evidence that a big-box use is financially feasible and shows that demand for such big-box properties exists. The fact that the property is occupied further substantiates demand.

4. Maximally Productive

The first step to determine if a use is the most profitable is to determine the value of the land. The value of the land is the base because the possible use must be at least as valuable as the vacant land. The use that provides the greatest value above the land value is usually the highest and best use; thus, whether segmenting the property by type or by investment class, ideally the use should be specified as narrowly as possible rather than in broad terms, but reference to a specific name retailer should be avoided, especially if the retailer is a current occupant as this may be reflected and be criticized as a value-in-use analysis. The potential use that provides the greatest return is the maximally productive use.

B. As Improved

The same four criteria for the highest and best use as vacant should be considered in an analysis of the highest and best use as improved.

1. Legally Permissible

It must be determined if the current use is a legally conforming use. If zoning has changed or if the improvements were built under a conditional use permit, reconstruction of the improvements may not be allowed should the original improvements be destroyed, and further research may be required.

2. Physically Possible
Consider the land to building ratio. If the land to building ratio is greater than what is typical for the current use, the improvements may be an underutilization of the site. Underutilization may suggest the current improvements are not the highest and best use as improved.

3. Financially Feasible

For most properties that are improved with big-box stores and related improvements, one of three possible highest and best use conclusions is likely.

- Retain the existing improvements for their current use.
- Renovate to address physical and functional items that need to be cured and/or convert to a different use to recognize changing trade area demand trends.
- Demolish the existing improvements and redevelop the site with a different use that represents the highest and best use of the site.

If the improvement is occupied and functional for the use for which it was designed, this is evidence that the improvements are financially feasible. If the property is vacant and, especially if it has been vacant for a considerable period, this is evidence that the current use may not be financially feasible and a second-generation use may be indicated.

Techniques like the land residual, feasibility rent analysis, and the use of profitability index are methods that may be used to test financial feasibility. Another practical method that may be considered is a simple analysis showing that an improved property should not be worth less than a vacant property. This methodology is particularly useful for big-boxes. Consider the following hypothetical:

An occupied store of 150,000 square feet has a typical land to building ratio of 5:1 or land area of approximately 750,000 square feet. The taxpayer asserts that the building is worth $20 per square foot based on comparable sales of deed restricted, converted stores, and/or vacant properties. This value implies the subject property is worth $20 x 150,000 square feet or $3,000,000. This $3,000,000/750,000 square feet of land area also indicates that land must be worth less than $4 per square foot. If comparable land sales indicate a value for land greater than $4 per square foot, then the market value for the subject property is either greater than $3,000,000 or the occupied property has reached the end of its economic life because the improvements offer no contributory value to the property’s total market value.

From this example, the comparable properties identified by the taxpayer are not appropriate for comparison to the occupied property or the current use is not the highest and best use. If continued use of the operating store is financially feasible, then the comparable properties offered by the taxpayer are inappropriate because the resulting value is less than land value.

The same test may also be used with rents. The $3,000,000 value implies that rent for the subject property would be approximately $270,000 annually using a market based capitalization rate of 9% as an example. Annual rent of $270,000 /150,000 square foot implies a rental rate of $1.80
per square foot. If comparable leased properties in the subject’s market reflect significantly
higher market rents than $1.80 per square foot then either the comparable lease properties are
inappropriate or the property is approaching or has reached the end of its economic life. Again,
the test reveals that the value of the land exceeds what is proposed as the contributory value of
the improvements.

Comparable land sales provide the benchmark for the lowest value a property can be as-if-
vacant; thus, the proper identification of land sales is an important step in determining the correct
highest and best use.

4. Maximally Productive

If the subject property is occupied, the current occupant should not be excluded from the
universe of potential tenants or buyers for the subject property. This shows there is demand for
the property. According to *Property Assessment Valuation*, International Association of
Assessing Officers, 3rd ed. (2010), p. 44 “In mass appraisal, the current highest and best use is
usually considered to be the current use, that is, buildings will not be immediately demolished or
replaced.” If the subject property is operating successfully, that fact supports the premise that
there is demand for the use for which the property was originally designed. Highest and best use
is likely for the continued use of the property in its current use. If the property is improved but
vacant, consideration should be given to what classification property the subject is and if there is
adequate demand for the property in the market.

For retail, the perceived worth of a specific property is relative to size, age condition; access;
traffic counts; proximity to major employment centers, the concentration cluster of surrounding
properties; population size and household purchasing power to name a few considerations. The
competitive advantage of a particular property will determine its relative position within the
market. A property that has significant advantages over other properties of the same use because
of location, demographics and economic forces will command higher prices and rents. As such,
differentiating properties into investment classes creates a logical hierarchy that reflects potential
market participants’ actions.

a. Investment Class A

Investment Class A big-box retail properties sell at the highest prices and lowest capitalization
rates. The first-generation user generally occupies these properties. Buyers of investment class
A, big-box retail properties typically are national investors such as real estate investment trusts
(REIT); insurance companies and retirement funds looking for newer improvements with a
creditworthy national or regional retail chain tenant under a long term, generally NNN, lease.
These properties are located in areas that generate the high retail sales per square foot, usually
above the chain’s nationwide average because they are in close proximity to higher income
customers, have greater visibility such as a corner lot location and greater traffic counts to name
a few factors. Leased Class A properties generally are subject to long remaining term leases.

b. Investment Class B
Investment Class B, big-box retail properties are usually slightly older properties that sell in the mid-range price level at mid-range capitalization rates. These first-generation properties are situated in good locations but not as well located as Class A properties. The retail sales per square foot usually meet or may exceed the chain’s nationwide average sales per square foot. These properties may still attract national investors but also investors in closer proximity regionally and locally to the subject. Remaining lease terms on these properties, while not as long as for Investment Class A properties, generally exceed 10 years.

c. Investment Class C

Investment Class C, big-box properties are nearing the end of their economic life for first-generation use, and may be classified as second-generation space. These locations do not meet the minimum requirements for a new improvement of the same use or renovation of the current improvements by the first-generation user. Retail sales at these properties are usually below the chain’s nationwide average. These properties sell toward the low end of prices and high end of capitalization rates. The continued use of the current use is likely an interim use. Remaining lease terms are relatively short, usually less than 10 years.

d. Investment Class D

Investment Class D, big-box retail properties sell at bargain basement prices and, when leased, indicate high capitalization rates. They are often vacant or soon to be vacant properties with a highest and best use for a second-generation user. The original market demand for these properties has moved to more desirable retail locations. These vacant properties possibly are ready for redevelopment for a different use (e.g., low end retail, office or warehouse). The original design used is no longer valuable or viable in the marketplace except at very low prices or rents by second-generation users.

X. THE THREE APPROACHES TO VALUE OF THE FEE SIMPLE PROPERTY RIGHTS

A. THE COST APPROACH

The cost approach to value provides a value indication that is the sum of estimated land value and the estimated depreciated cost of the building and other improvements. *(Property Assessment Valuation, 3rd ed., IAAO)*

1. Introduction

The cost approach is a two-step process that provides a value indication of the land and an estimate of value for the cost to build a new or substitute property. Adjustments for depreciation caused by age, utility, or external factors are applied to the improvements and the land value and building value less depreciation are added together for a total property value. The approach is premised on the principle of substitution that asserts a prudent buyer would pay no more for a property than the cost of buying a substitute property of equal utility and without undue delay. In other words, buyers of properties, including big-box properties, consider the costs, rents, timing,
and prices of other properties and how those factors contribute to value. The cost approach reflects market behavior, especially in the valuations of new properties, proposed construction, or renovations and special purpose properties, or in the case of big-box properties for which comparable sales are scarce.

2. Land Valuation

An accurate land value estimate is critical to the development of a reliable cost approach. Comparable land sales should have the same highest and best use as the subject property and should be similar in location, traffic count, demographics, zoning, size, visibility, access, and any other attributes deemed important by buyers and sellers.

3. Strengths of the Cost Approach

Courts frequently rely on the cost approach because it inherently values the fee simple property rights by eliminating debate about leases and deed restrictions. The cost approach is useful when comparable sales and rental data are insufficient or lacking. Replacement cost new, as opposed to reproduction cost new, typically excludes any functional obsolescence relating to design and utility, like super adequacies for example. The cost approach can serve as a test of reasonableness against claims that build-to-suit costs exceed the market value for the new improvements.

4. Weaknesses of the Cost Approach

Limitations in the cost approach are attributed generally to estimating depreciation and entrepreneurial profit. The economic age-life method and market extraction method are widely used by appraisers to estimate depreciation because of their simplicity in application but lump sum deductions and straight-line depreciation may be oversimplified. Effective age and remaining economic life are based on an appraiser’s subjective opinion and tend to be less reliable as the property ages. The breakdown method is more detailed in measuring depreciation but many forms of depreciation are difficult to support with market evidence and in these cases there is a greater likelihood of a methodology’s misapplication. In the case of big-box properties some of the limitations are lessened as these properties tend to be very well maintained and continued occupancy indicates functional obsolescence to be minimal.

Entrepreneurial incentive/profit is defined as “a market-derived figure that represents the amount an entrepreneur receives for his or her contribution to a project and risk; the difference between the total cost of a property (cost of development) and its market value (property value after completion), which represents the entrepreneur’s compensation for the risk and expertise associated with development.” [Id page 76, The Dictionary of Real Estate Appraisal, 6th ed., Appraisal Institute (2015)] The estimate of entrepreneurial profit, based on analysis of recent sales of similar properties and/or interviews with developers of similar improvements, is often difficult to support due to the lack of sufficient market evidence. It is often calculated as a percentage of direct and indirect costs and included in the total replacement cost of the improvements.

5. Special Purpose Property
Owners/users of big-box retail sometimes assert that the property is a special purpose property. A special purpose property is “unique” and calls for special construction materials. Sometimes retailers will identify their properties as an owner-user type property rather than a single tenant big-box property to give the impression that the property is customized for a particular user rather than portraying the property as a big-box prototype store. By presenting the property as a special purpose property, retailers introduce the idea that the property is built specifically for a particular use and is obsolete for any other similar first-generation big-box retailer as soon as the building is constructed. They claim that valuing the property as it was built is a value-in-use and not representative of market value or value-in-exchange. As the name implies, big-boxes are just large open spaces; remove the branding features of the façade and the personal property inside, and white wash the walls and each looks similar to another. Big-boxes may easily be adapted for another single user for the same purpose or a similar purpose for which it was originally constructed.

6. Applications

When examining all of the potential differences between the subject and the comparable properties used in the sales comparison and income capitalization approaches, the value of the cost approach emerges more clearly. A carefully developed cost approach may be the most reliable approach for new properties that have minimal accrued depreciation and less reliable for older properties, unless there is sufficient market evidence to support entrepreneurial profit and depreciation estimates.

B. SALES COMPARISON APPROACH – FEE SIMPLE VALUATION

Based on the concept of value in exchange, the sales comparison approach to value compares the property being appraised with similar properties that have recently sold. The characteristics of the sold property are analyzed for their similarity to those of the subject of the appraisal. (Property Assessment Valuation, 3rd ed., IAAO)

1. Introduction

The Sales Comparison Approach to value is commonly employed in the appraisal process because it closely reflects how buyers and sellers in the marketplace engage in property transactions. The Sales Comparison Approach is also heavily influenced by the economic principle of substitution, which holds that properties demonstrating similar economic utility will command similar prices. Hence, the maximum value of a property or highest price a property will likely obtain is determined by the cost of purchasing a substitute property of similar design, function and utility. This is a straightforward approach that studies the market’s reaction to similar comparable properties and is particularly reliable when there is ample data available in the market from which to make appropriate comparisons.

2. Sales Selection and Market Segmentation
The selection of the comparable sales is essential for the sales comparison approach to reach a reliable conclusion of value. Narrowing the highest and best use of the comparables assists an appraiser in identifying those properties that are most similar to the subject. Once the highest and best use for the subject is determined, the subject may be classified into one of the investment classes (A, B, C, or D as described in greater detail previously in the highest and best use section of this report) and/or segmented by type such as freestanding retail, home improvement, discount department store, etc., if possible. In the case of big box properties, these buildings are configured as single occupant properties and may be modified for other single occupant uses, so while it is ideal to narrow the property’s highest and best use and those of the comparable sales as much as possible, care must be taken not to identify a specific user, as this may be interpreted as a value in use. Relevant characteristics such as size, age, condition of the property, access, traffic counts, proximity to major employment centers, the concentration cluster of surrounding properties, and population size are among factors that will influence a big box retail property’s competitive position in the market. These determinants will contribute to establishing the appropriate trade area and also the suitable comparisons to use in the sales comparison approach. As such, differentiating the subject and comparable properties into segments such as investment classes or retail type creates a logical hierarchy that appropriately reflects market behavior.

3. Deed-Restricted Comparable Sales

Deed-restricted comparable sales should not be used in ad valorem valuations for the following reasons.

- Deed-restricted sales are not sold into a free market of all willing purchasers.
- Deed-restricted sales are not sold for their highest and best use.
- Deed-restricted sales are not made by a properly motivated seller as the motivation of the seller is to restrict the property from future use by any form of competition and not to maximize its price.

4. Highest and Best Use and Appropriate Sales for Comparison

For properties to be considered the best comparable properties to the subject property, they should have the same highest and best use. The less similar the highest and best use, the less comparable the sales properties are for the subject property. If the highest and best use is not reasonably similar, then a comparable property should be rejected in this approach. As previously discussed in the highest and best use section, if the subject property is an occupied property, it should be compared only to similar occupied properties. A vacant property should not be used as comparison with an occupied property, if the properties have a different highest and best use that may be evidenced by the fact that demand exists for the occupied property and not for the other that is vacant. Deed restricted properties that intentionally limit competing uses almost always have a different highest and best use than properties without deed restrictions and do not serve as appropriate substitutes.

5. Fee Simple/Leased Fee
Commercial big-box properties are often leased to a tenant. A fee simple valuation does not mean that you disregard the lease in place and appraise the subject property as if vacant or assuming it may only be owner occupied. This is a common misconception that sometimes leads an appraiser to either exclude the income approach from consideration or discredit the income approach in a big box property valuation. Fee simple does not mean vacant or owner occupied. To clarify, fee simple refers to the bundle of rights that convey, and a property may sell with a lease and be considered fee simple, subject to a lease. If the subject property has a lease, that lease may qualify as a rent comparable if the rent is at market. Regarding a comparable property, the appraiser should determine whether the rent for the comparable sale is consistent with market rent. If the rent is above market or below market, an adjustment may be necessary if the appraiser wants to use the sale as evidence of market value.

6. Value in Use

The misunderstanding of fee simple (meaning owner occupied or vacant) often leads to additional assertions that the property is uniquely customized and only valuable to a particular user. This portrayal of the subject property as a customized, special purpose property as opposed to standard, big box retail store is often advanced by additional claims that the property is functionally obsolete for the market and only valuable to the current user as a value-in-use. The subject’s current occupant should not be removed from the pool of prospective, interested buyers or users of the property and that the current use of the property may prove that demand for the property exists. The fact that the property is occupied and operational may affirm that the current use of the property is likely also to be the highest and best use. It may also be determined that value-in-use and market value (value-in-exchange) are equivalent in such cases.

7. Sale Leaseback and Verifications

It is essential that each sale is verified to ensure it meets the necessary requirements of an arm’s length transaction between a willing buyer and a willing seller. One should disqualify any sale that is not a valid market transaction. Especially in the case of sale leaseback verifications, one should confirm these sales rather than simply rely on information provided by data services to determine whether the circumstances meet the market value criteria that would allow the transaction to be used as an appropriate comparable to include in a sales comparison approach.

8. Application of the Sales Comparison Approach

It is not with great frequency that sales of newly constructed big box retail buildings, as in build-to-suit properties, convey in the open market; however, there are investment grade A and B properties that sell, many times to investors that see an opportunity in buying either a store with relatively new improvements and a high-quality tenant, or as a store vacated by former high-quality tenant where the space may be reused by another quality tenant. In these cases, there may be support also for an income approach, with rents and capitalization rates to use in additional analysis. Other lower investment grade properties will also sell in the open market, sometimes as junior anchors or as properties to be owner-occupied. The Sales Comparison Approach is a well-founded methodology to rely on when there is ample data available in the market.
C. INCOME CAPITALIZATION APPROACH

1. Introduction

One of the three approaches to value, based on the concept that current value is the present worth of future benefits to be derived through income production by an asset over the remainder of its economic life. The income approach uses capitalization to convert the anticipated benefits of the ownership of property into an estimate of present value. Big-box properties are mostly owner occupied by retailers but often these properties are owned by investors and occupied by the retailers under a long-term lease; thus, the use of the income capitalization approach to value can be utilized with empirical evidence supporting market rent estimates and overall capitalization rates. *(Property Assessment Valuation, 3rd ed., IAAO)*

The income capitalization approach converts all expected net benefits received from the lease of a property, including annual net operating income and reversion, into an opinion of present value. The two methods of income capitalization are yield capitalization and direct capitalization.

a. Yield Capitalization (Discounted Cash Flow)

Yield capitalization considers a series of cash flows over time together with any reversion value or resale proceeds. The basis of the yield capitalization process is to discount the value of the future income streams to present value and then add those benefits to a present value of a reversion amount as an estimate of what the property will sell for at the end of the projected holding period. A criticism of this approach in jurisdictions where market rent is the underlying valuation criteria is that it incorporates speculative modeling criteria and is rarely used by market participants in the sale and purchase of big-box properties. Also, courts are often skeptical as to the reliability of this method.

b. Direct Capitalization

Direct capitalization uses the relationship of one year’s net income, usually the first year of ownership, to conclude a value. This method is preferred by buyers and sellers of big-box properties and is often quoted on broker marketing flyers and emails. This is the generally accepted method by appraisers and receives greater acceptance in the courts. For mass appraisal, direct capitalization is used because it is simpler, less speculative, and has more market evidence.

2. Direct Capitalization Methodology

a. Identification of Lease Comparable Properties

The first step in the direct capitalization approach is to determine market rent. *The Dictionary of Real Estate, supra*, p. 140:
the most probable rent that a property should bring in a competitive and open market reflecting the conditions and restrictions of a specified lease agreement, including rental adjustments and revaluation, permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements (TIs).

Market rent is the essential basis of fee simple valuations. *The Appraisal of Real Estate, supra.* p. 447:

> Market rent is the rental income a property would command in the open market. It is indicated by the current rents that are either paid or asked for comparable space with the same division of expenses as of the date of the appraisal . . .

Rent for vacant or owner occupied space is usually estimated at market rent levels and distinguished from contract rent in the income analysis. In fee simple valuations, all rentable space is estimated at market rent levels. . . .

To determine market rent, recent actual lease data from properties of reasonably comparable utility should be used. The most representative lease data will be leases entered into prior to but as close to the effective date of the valuation as possible. Further, the lease data should be drawn from the same market as the subject property which may not be limited to local buyers only. Just as the comparable sales properties are selected based on the highest and best use segmented into investment classes, lease comparable properties similarly should be segmented. If such comparable rental data is limited, it may be necessary to consider slightly different investment classes with appropriate adjustments. Build-to-suit and/or sale leaseback transactions, if verification deems them open market and arm’s length transactions, may be included to establish market rent.

For a fully occupied, well maintained, functional big-box property, recent comparable rents for first-generation space (Investment Classes A and B) are most suitable for consideration of market rent estimates:

> First-generation space – a building or space designed to be functionally and economically efficient for the original tenant or a similar class of tenants over a period of time during which the space retains its original utility and desirability. *(The Dictionary of Real Estate Appraisal, supra.* p. 210)*

Investment Classes C and D improvements are losing or have lost their appeal to first-generation users and may be suitable only to second-generation users. Recent comparable rentals of these types of properties are appropriate for consideration of market rent estimates for subject properties that are nearing the end of their useful lives for their intended use and utility when built. *The Dictionary of Real Estate Appraisal* defines second-generation space but the proposed definition is a better reflection of second-generation space as it mimics the definition of first-generation space and identifies the importance of demographics to big-box retailers:

> Second-generation space – a building or space whose design is no longer functionally and/or economically efficient for the original tenant or a similar class of tenants. The space may no
longer retain its original utility and/or desirability for the original tenant but may be used by a
tenant other than the original or similar class of tenant.

Sometimes when a store is vacant, a temporary tenant, such as a Halloween store, will occupy
the space for a short period of time. This type of tenant will not require significant tenant
improvements depending on how long they intend to remain in the space. As they are short term,
rent likely will not reflect market rent but may be bargain rates or excessive rates. Short term
tenants are rarely regarded as reliable lease comparable properties.

**b. Verification of Comparable Leases**

The same steps to identify and verify comparable sales properties also must be done for
comparable leases. The verification process is similar to the process to determine if a sale is an
arm’s length sales transaction. The landlord and tenant should be unrelated parties that are
knowledgeable and are acting in their own self-interest not under duress.

**c. Rent Adjustments**

Several factors may influence rents. Just as in the sales comparison approach, older lease rates
may not reflect market and may need to be adjusted for time and market conditions. If the market
has been generally stable, no adjustments may be needed. Also, the use of concessions, rent
escalations, expense stops and tenant improvement allowances, among other factors, may change
over time and under differing economic conditions. A comparable lease that has concessions
should be adjusted if lease concessions are not a common occurrence as of the effective date of
the valuation. Rent escalations that exceed typical market rent arrangements need to be
discounted so that effective rent is not overstated relative to market rent. While consideration
should be given to any other adjustments relating to physical characteristics and market factors
that may potentially influence rents, attempts should be made to obtain data within a reasonable
period of time prior to the effective date of appraisal so as to limit the number adjustments
needed.

**d. Vacancy and Collection Loss**

Vacancy is typically determined by examination of the market, however, in the case of national
credit, single-tenant big-box retailers, the likelihood of incurring any vacancy or collection loss
during the term of the lease is highly improbable. Often a vacancy and collection loss, even if
negligible, is justified for future uncertainty.

**e. Operating Expenses**

The comparable leases will indicate the typical lease structure in the market. Whether the subject
is owner occupied or leased, the market rent used in the direct capitalization approach should
reflect the lease structure most common in the subject’s market. It is imperative that the income
stream of the comparable leases be the same as the income stream developed in the income
approach so that the division of expenses between owner and tenant are accurately reflected
based on market activity. Only expenses that are typically paid by the owner are used to
determine the net operating income even if the actual lease terms differ.

In big-box retail, the lease structure generally is NNN or absolute net, so expenses to the owner
are nominal. In the NNN lease, the owner may only be responsible for structural repairs and a
management fee. As big-box property is occupied by a single tenant, management involvement
is minimal. In an absolute net lease structure, the only expense to the owner typically would be a
minimal management fee.

f. Capitalization Rates

The Dictionary of Real Estate Appraisal, supra, p. 31 defines capitalization rate as:

[a] ratio of one year’s net operating income provided by an asset; used to convert income
into a value in the application of the income capitalization approach.

A capitalization rate reflects the investor’s potential return on its investment. The argument is
made, not just in big-box appeals but generally, that the leased fee value does not derive a fee
simple capitalization rate. Leased fee estate is an appraisal term not a legal term and is the
valuation of the actual contract rent in place. The use of market rents eliminates a leased fee
valuation as discussed under the property rights adjustment section of the paper.

A market derived capitalization rate from verified sales of properties of similar utility, i.e. the
same highest and best; the same investment class and the same or reasonable comparable market
as the subject property should reflect a reliable conclusion. The capitalization rate will reflect
market participants’ actions with regard to risk. The investment class segmentation will take into
consideration the likely creditworthiness of the tenant; the remaining term on the lease and the
physical attributes of the real property.

As support to the market derived capitalization rate, investor surveys may be examined but not
relied on for the capitalization rate without adjusting for what the surveys actually measure.
Investor surveys cast a wide net and may not be market specific. Surveys reflect investor
expectations, not actual market transactions. It is essential to understand the range indicated in
investor surveys rather than simply relying on the average. The average will likely overstate the
capitalization rate for Investment Classes A and B big-box properties and understate the
capitalization rate for Investment Classes C and D big-box properties.

The band of investment technique may also be used to determine overall capitalization rates
using criteria that factors in current debt and equity parameters.

The application of this technique for big-box properties that are being valued, assuming they are
leased at market rents, results in an overall capitalization rate that reflects the required debt
service payment to the lender and the equity dividend rate (equity cap rate) to the investors. The
mortgage constant is readily available through a survey of active lenders or from mortgage
information providers who survey and report available terms, interest rates, amortization rates,
etc. on a periodic basis.
Equity dividend rate information is more difficult to obtain. The best source is leveraged comparable sales from which equity dividend rates can be extracted. Because comparable sale data reflects existing leases that may be leased at, below, or above market rent, the extracted equity dividend rates may have to be adjusted to derive fee simple at market rent capitalization rate conclusions. The technique works best when there is sufficient comparable leveraged sales data from which to extract equity dividend rates. If the data is not sufficient, opinions as to appropriate capitalization rates may be elicited from market participants. This technique reflects financed transactions but does not reflect all-cash transactions, which for certain property types and markets may be a significant part of the transaction market. Care must be taken in this instance to relate the technique to those properties that would likely sell on a leveraged basis.

XI. RECONCILIATION

An appraiser should consider all three approaches to value to determine a property’s market value. Law often requires appraisers to value properties as fee simple estates for ad valorem taxation, and it is important to employ all appraisal approaches that will lead to credible valuation conclusions, unless a jurisdiction has specific requirements regarding what methodologies to consider, disqualify, or rely on.

There are some recurring contentious points that arise in tax appeals for big box retail properties. One of the more common issues begins with the misunderstanding of fee simple estate and leased fee estate. The misconception starts with the notion that fee simple means unencumbered by a lease, which is often misinterpreted to mean vacant or owner-occupied. A property may be appraised as fee simple, even if it has a lease. It does not mean the income approach is inapplicable in the analysis of the property. On the contrary, if a property is leased at market rent this may help the assessor arrive at a supportable conclusion of market value. The issue to resolve is whether the rent corresponds with market rent.

The Highest and Best Use is a central part of the valuation process, with the identification of similar properties as a key point. Whether you segment the property by investment class or retail type, the main thing is to use suitable comparisons in the analysis. Land sales should have the same zoning and highest and best use, among other important characteristics, and improved properties should be comparable. Occupied and operational properties are assumed to have a current use that is estimated to be the highest and best use should not be compared to dissimilar properties that are vacant or deed restricted. The sales comparison approach echoes many of the fundamentals outlined in the highest and best use, particularly the steps to take in identifying and analyzing comparable properties as supportable benchmarks of value for the subject property.

The Cost Approach should not be undervalued in its usefulness and applicability to fee simple valuations. This approach inherently values the fee simple estate, and may provide a reliable indication of value, especially in the appraisal of new buildings or for those properties that have minimal accrued depreciation. Developers use this approach when determining financial feasibility for a project, so the application of the cost approach directly replicates market behavior. When the replacement cost is used, the cost approach also eliminates many issues.
associated with functional obsolescence. This can be particularly important when an assessor is confronted with big box retailers’ claims that a property’s appraised value is based on value-in-use and not value-in-exchange. Big box owners will argue that their big box store should be considered a customized property that is functionally obsolete in the market to any user other than the current occupant, and that the value of the property is driven by that user and not by the market. However, the subject’s occupant and user should not be excluded from the universe of prospective buyers/users and current use of the property if occupied and functional may also the highest and best use. A standard big box retail store may be easily converted for use by another single tenant retailer, and the cost approach can substantiate that. Another benefit of the cost approach is that it can also help an appraiser determine market rent when big box owners claim they are paying above market rent, which is often the argument with new build-to-suit properties. A cost approach can provide support in determining whether there is excess rent to consider.

The Income Capitalization Approach emulates market behavior from the perspective of investors particularly in big-box, net leased sale transactions. Investors and sellers buy a property for the income stream, and they understand that there is a direct relationship between income characteristics and property value. A property with a high-quality tenant and long term lease will likely have a lower cap rate and higher value than an older property with a shorter lease. An older property will usually have a higher cap rate and lower value. The income approach, despite being a central component for most commercial property valuations traded in the open market, is often criticized by big box retailers as not being an appropriate valuation method for a fee simple estate valuation. As mentioned earlier, this misunderstanding states that valuing a property with a lease is not valuing a property in fee simple. The argument that a property should be analyzed as if unencumbered by a lease, or as an owner-user type property is not only a misinterpretation of fee simple but also an attempt to disqualify the income capitalization approach as a credible analysis. In jurisdictions that require a fee simple valuation, an income capitalization approach will consider the lease at market rent, where leased fee equals fee simple. If the property is encumbered by a long-term lease that is below market, ad valorem taxation generally requires that the appraiser disregard the lease and consider the property at market. The same methodology would apply to an above market lease.

Common recurring issues that arise in big box valuations and tax appeals include how to handle deed restricted properties, dealing with claims of functional obsolescence, assertions that a property’s assessment is based on value-in-use, addressing rents that are purported as above market, using vacant stores as comparisons for occupied stores, and clarifying the fee simple meaning as if vacant and unencumbered. It is difficult to address all of these issues in one approach to value, and developing all three approaches reinforces one another. Each approach to value has its strengths and its weaknesses. The strengths are magnified when the approaches are supplemented and weaknesses are amplified when approaches are eliminated.

A cost approach may serve as a reliable indication of value for properties that are new or well-maintained or when there is a scarcity of sales in the market, but it may not be as applicable for middle age properties with significant depreciation. The sales comparison approach gives strong support when there is ample data to identify suitable substitute properties but is less reliable when true comparisons are not available. The income capitalization approach is a
method used by investors to convert income into value, but this approach is only dependable when the data is obtainable from the transactions between buyers and sellers. Jointly these methodologies will enhance the credibility of an equitable big box retail property assessment.

When there is more than one approach to value utilized, the appraiser should reexamine the entire appraisal, especially for accuracy, relevance, and market support of all of the data in each approach, and reconcile the differences in the value conclusion between the approaches. The final step is to exercise judgment as to what approach or approaches to rely on for a final conclusion of value.
APPENDIX A
ISSUES RAISED IN TAX ASSESSMENT APPEALS
OF SINGLE-USER PROPERTY
CASE LAW DIGEST

I. ORGANIZATION

A New York trial court accepted that the build-to-suit, NNN lease, single-user, retail market was a specific submarket of the national, general commercial market. Data from this national submarket should be the source for data to value these properties. The New York history behind this case and the case itself will be discussed first.

The remaining cases are categorized by state and the issues addressed in the case are identified immediately after the citation. Each case has been reviewed for negative treatment within its jurisdiction on the issue for which it has been included. Parallel citations are provided when possible and unpublished decisions are noted with Westlaw citations. Trial court/administrative decisions are final unless otherwise noted. Citations for trial and administrative decisions are the caption of the case before the trier of facts if there is no state reporter or Westlaw citation available. Some decisions were provided by an assessor or counsel and are not available on Westlaw.

Citations within a case have not been checked to determine if the citation supports the proposition for which it has been cited by the court. The reader is well advised to do so on his own as on occasion a court may extend a holding to fit the facts of the case it is reviewing. These internal citations also provide additional research.

II. THE NEW YORK DRUGSTORE WARS AND THE RITE AID CASE


Issues: highest and best use, market rent

The New York war of the drugstores against tax assessments begins with this case. The taxpayer challenged its 2002 and 2003 assessments in the town of Colonie, county of Albany, owned by Columbia Plaza and leased to the taxpayer. The property was located on a corner lot as a freestanding store with a drive-thru pharmacy window and parking lot. Taxpayer submitted an appraisal for a value of $1,950,000 for 2002 and $1,550,000 for 2003. The assessor submitted an appraisal for a value of $3,100,000 for 2002 and $2,750,000 for 2003. The trial court, with a few adjustments, accepted the taxpayer’s appraisal report.

Neither appraiser did a cost approach, but both did sales and income approaches. The differences in value were the result of the determination of highest and best use. The assessor’s appraiser used the sales of three newly constructed, national chain pharmacies and rents from four national chain pharmacies located nearby. The taxpayer’s appraiser used no sales of national chain pharmacy properties but rather a pet store; a restaurant; a strip mall and a specialty market. For rents, he used five nearby property leases of a thrift store that was a former Rite Aid; a retail
woodworking store; a real estate brokerage storefront; a video store and a national pet supply
center.

The taxpayer’s appraiser rejected the use of market data from national drugstore chains even
though there was sufficient market data asserting the leases are based on build-to-suit costs that
create above market rents and are not open-market transactions. He also asserted that a drugstore
is like any other retail property. The trial court accepted these explanations and the reviewing
court deems the explanations plausible.

There is a second case, same players, where the petitioner again prevailed based on the same


Issues: arm’s-length sale

The property was assembled from 16 parcels in 1999 encompassing one block with frontage on
four streets. In 2000, existing structures were demolished and a freestanding, national chain
pharmacy store was constructed. In 2001, the property sold on the open market for $4,000,000
and again in 2003 for $4,850,000. Taxpayer appealed its 2002, 2003 and 2004 assessments of
$2,800,000 for all three years.

Taxpayer’s appraiser valued the property at $1,750,000 for 2002, $1,740,000 for 2003 and 2004.
The assessor’s appraiser valued the property at $4,000,000 for 2002, $4,250,000 for 2003 and
$4,400,000 for 2004. The trial court rejected the petitioner’s challenges citing the two sales as
representative of fair market value far in excess of the assessed values.

Taxpayer’s appraiser testified the sales of the property did not alter his opinion and the taxpayer
pointed to the decisions cited immediately above as support that the sales were not market value;
but this time, the taxpayer’s evidence was given no weight as it “flew in the face of objective data
found in the marketplace.” The reviewing court affirmed the trial court citing appellate decisions
holding that recent sales of the property at issue are the best evidence of value.

The first two decisions are fundamentally at odds with this decision.


Issues: NNN national submarket, arm’s length sale

Taxpayer challenged the 2000, 2001, 2002, 2003 and 2004 assessments of the property in which it
was a tenant. The property was a corner lot assembled from 10 smaller lots in 1999. The building
was constructed by taxpayer in 2000 at the cost of $2,400,000 and sold the same year for
$3,600,000 in a portfolio of properties. In 2001, it sold again for $4,100,000 subject to a mortgage
of $3,700,000 and NNN leased to taxpayer until 2023 with renewal options. The lease provided
that the fair market value in 2000 was $4,100,000 and was not a financing arrangement. The
assessment value for all years was $2,021,600.
The taxpayer submitted an appraisal of $1,600,000 by the sales comparison approach and $1,300,000 by the income capitalization approach for all years. The assessor submitted an appraisal for $3,500,000 for all years based on the same approaches to value. At trial, the assessor also presented testimony of an expert in the net-lease real estate market who valued the property at $4,600,000. The judge dismissed the appeals.

The reviewing court noted that the taxpayer’s expert testimony that build-to-suit leases inflate the value above fair market value had been accepted twice and the same testimony rejected once based on objective market evidence of two sales of the property. Here there a sale and additional expert testimony of a national market for drugstores that showed an average purchase price of $4,000,000. This evidence distinguished it from the two other cases in which petitioner prevailed. The court reaffirmed the lower court decision.


Issues: fee simple; long term lease; NNN submarket

The taxpayer was under a 20-year, NNN lease of a freestanding pharmacy built to its specifications in 1999. The assessed value for all years was $2,500,000. This time the taxpayer’s appraiser claimed that fee simple meant unencumbered by a lease. He valued the property at $1,730,000 for 2004 and 2005 and $1,740,000 for 2006. He used no properties that were occupied national drugstore chains for use as comparable properties and two of the sales he produced were of build-to-suite stores that had been abandoned by national pharmacy chains: one was occupied by Goodwill and the other was vacant.

The appraiser for the assessor used almost exclusively national drugstore chain build-to-suit sales and leased properties. He testified that if the contract rent equaled the rent that could be obtained in the market that is a fee simple valuation. He valued the property for $3,600,000 for 2004 and 2005 and $3,900,000 for 2005. The assessor also provided the testimony of an expert in the NNN drugstore market who attested that national drugstores are a subsector of the larger national commercial real estate market, noting factors such as location, credit worthiness of the tenant and the term of the net lease differentiated drugstore assets from other commercial real property. Perhaps the other compelling factor for the property appraiser in this case was the purchase price of the vacated drugstore by Goodwill for $3,225,000.

The trial court dismissed the appeals. The reviewing court affirmed.


Issue: sale of the subject

The property originally was built for Eckerd, who was later bought out by Rite Aid. Construction costs were roughly $2,500,000. The store sold in 2005 for $3,600,000. It was assessed for 2008, 2009 and 2010 at $3,950,000. The trial court accepted the valuation testimony of the taxpayer, and disregarded the sale price of the property.
The reviewing court noted that the issue of build-to-suit now had been raised numerous times. It restated the principles in *Gilcrist* and *Brooks, supra*, that a recent, open-market transaction is the best indicator of value. It held that the trial court’s decision to accept the petitioner’s value went against the weight of the evidence of the sale, and the reviewing court reversed the decision.


**Issues**: second-generation; sale of the subject

The taxpayer appealed the assessments for 2011 and 2012. The property was built to suit in 2006 and leased to the taxpayer on NNN terms for 20 years with five renewal options. The developer sold it in 2007 for $5,512,500. It was assessed for $2,500,000. For the first time, build-to-suit is referred to as “first-generation” space, meaning it was built for and occupied by the original tenant.

The appraiser for the taxpayer asserted a value of $1,600,000. The appraiser for the assessor asserted a value of $3,650,000. Neither party did a cost approach but both developed a sales comparison and income capitalization approach. The taxpayer used primarily “second-generation” sales while the assessor used “first-generation” retail drugstores. In the income capitalization approach the taxpayer used no drugstore leases and the assessor did use drugstore leases. Both sides agreed the lease for the subject was above market, as it was entered into at the pinnacle of the real estate boom just before its collapse, and neither attributed the above market rent to the fact that the property was built to suit.

The taxpayer presented yet a third argument claiming that fee simple required the use of second-generation rents as reflective of market rents for the locality, as opposed to properties encumbered by above market rents based on build-to-suit construction costs. In opposition, the assessor argued that there is a substantial national submarket for NNN retail leases of first-generation space and the property should be valued in its as is condition as first-generation space.

The court noted that several decisions had addressed the issue of the proper method, which is to value first-generation drugstores without clear direction, and further recognized that there were no precedential appellate decisions on the issue.

The court determined that the subject property should be valued in its current condition using comparable sales of similar first-generation properties, in other words, freestanding drugstores encumbered with long-term leases. The court declared also that second-generation leases were not comparable. It points to the recent sale of the property as support for the decision even though it occurred before the market collapse.


**Issues**: fee simple; NNN lease submarket
These cases were handed down on July 10, 2015 by the trial court. The taxpayer was unsuccessful in both cases and filed both to the court of appeals unsuccessfully. Taxpayer then filed a consolidated petition for certiorari with the United States Supreme Court asserting that its equal protection rights were violated when its property was not valued the same as second-generation space in the same locality. The petition was rejected.

The process of accepting an appeal is discretionary with no reason for given for denying and no interpretation of merit provided.

In Hayworth, taxpayer challenged the 2009, 2010, 2011 and 2012 assessments and in Huseby, it challenges the 2008, 2009, 2012 and 2013 assessments. Both properties were leased by the taxpayer under 20-year NNN leases. The first property was built in 2003 and the second property was built in 2002, both under build-to-suit arrangements with taxpayer’s predecessor, Eckerd Drugs. In each case, the property was assembled from smaller parcels to occupy corner locations. The first property sold in 2003 for $4,650,000 and was assessed for $3,750,000. The second property sold in 2005 for $4,903,634 and was assessed for $3,650,000. Both sales were open market transactions.

The expert for the taxpayer concentrated his analysis on the fee simple using the distorted definition of unencumbered by any lease. He did not complete a cost approach but did a sales and income approach. He valued the first property at $1,000,000 to $1,100,000 and valued the second property at $1,440,000 to $1,490,000. His comparable properties were general retail type stores in the same geographic location but none of his comparable sales was drugstores or build-to-suit properties. While he acknowledged that 12 recent sales of retail drugstores had occurred in the region, he concluded it was not appropriate to use them and gave them “little weight.”

The assessor did not contest that build-to-suit properties may result in above market lease rates but the assessor’s expert testified that there is an established national submarket for the sale and purchase of build-to-suit, net lease, national chain drugstores that provides substantial market data and that this data should be used primarily to value the properties. He specified several publications that research and analyze this specific submarket. All of the assessor’s expert’s comparable properties were of national drugstore locations. There was no challenge that this submarket exists.

For the same reasons as stated by each for the sales comparison approach, the taxpayer did not use lease data from national drugstore chains and the assessor did.

The New York court stated:

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applicable market as evidence of value demonstrates the invalidity of the expert’s conclusions using the income capitalization method.

III. BY JURISDICTION

A. CONNECTICUT

Union Carbide Corp. v. City of Danbury, 1999 WL 956659, sustained 257 Conn. 865 (Conn. 2001).

Issues: admissions against interest; sale leaseback, arm’s length transaction

Taxpayer built a “magnificent, state of the art, futuristic” corporate headquarters. The parties agreed that the highest and best use was for the continued use as a corporate headquarters. That is all to which the parties agreed. The counsel for the city did an excellent job dismantling the taxpayer’s credibility by establishing that the taxpayer used a “different purpose, different story” approach, depending on the forum, in asserting his opinion of value of the property (admissions against interest).

Another significant element of the case was the appropriateness of relying on the sale-leaseback of the headquarters building. The trial court held that the sale-leaseback transaction was an open market transaction and not a financing arrangement. The sale offering was on the open market and sold to an unrelated third party, with no evidence that the taxpayer was under duress. To the contrary, security and exchange filings established the taxpayer was flush with cash. Relying on the evidence of an arm’s length transaction between willing market participants bolstered by Internal Revenue Rules, the court determined the sale-leaseback was a valid sale and not a financing arrangement:

1. It met FASB rule 13 standards for treating the transaction as a sale.
2. The sale met applicable IRS standards that the purchase price did not exceed fair market value and the contract rent did not exceed market rent.
3. The lease did not transfer ownership to the taxpayer at the end of the lease term; there was no purchase option and the lease term was less than 75% of the economic life of the building.
4. The transaction also qualified as a sale under IRS standards because the buyer made a substantial down payment to the buyer, there was no seller financing and there was no third-party guarantee for the payment of the rents.


Issues: corporate headquarters; sale leaseback transaction; cost approach; value-in-use

The property was a large corporate headquarters built for $167,261,318 completed in 1984. In 1985, the taxpayer entered into a sale-leaseback agreement with a trust. First, the taxpayer leased the land to the trust and then later sold the improvements separately to the trust for $250,000,000. The taxpayer then subleased the land and leased the improvements. In 1987, the assessed value...
was $250,665,000. The assessed value remained unchanged and the taxpayer did not challenge it until 1996. The Board of Assessment dismissed the case and the taxpayer appealed.

The trial court de novo reduced the value by intermingling each party’s cost approaches. The trial court used the city’s reproduction cost and depreciation estimates and the taxpayer’s land value and entrepreneurial profit estimate to arrive at $233,531,549. Both parties appealed.

The taxpayer argued that the court determined the value based on its value-in-use to the taxpayer, and used the reproduction cost approach and not a replacement cost approach. The taxpayer asserted that Connecticut law prohibited the use of the reproduction cost approach because the assessed value must be its fair market value. The court rejected the argument:

Contrary to Aetna’s argument that the court excluded market evidence and ignored market objectives, the court considered [taxpayer’s] market based inefficiency theory and specifically chose to reject it. That was consistent with the court’s adoption of [assessor’s] opinion that “the highest and best use is a continuation of the present use by Aetna as a corporate headquarters. We refuse Aetna’s invitation to read into that statement of highest and best use the court’s intention to value the subject property exclusively on the basis of its “use value” to Aetna and Aetna’s employees because such an interpretation is inconsistent with the court’s decision when read as a whole [citation omitted]. Aetna’s use of the subject property and its value to Aetna are clearly representative of the subject property’s general market value as a corporate headquarters and were considered properly by the court along with all the additional relevant evidence.


**Issues**: built-to-suit, income approach, highest and best use; sales comparison approach; power centers

The improvements were built for and continuously occupied by the taxpayer. Both parties agreed that the highest and best use was for continued use as a home improvement store. The parties also agreed that although the property was owner occupied, it is the type of property that would appeal to not only to an owner-user but also to an investor who would want it for its steady and reliable income stream; thus, the market for potential buyers was not limited to owner occupants. Both parties also agreed that the income approach was the most reliable method to value income producing property.

Connecticut law allows the use of the income approach only if the property is actually leased. This is the same requirement in Michigan. As a result, the court rejected the income approach leaving a cost approach by the taxpayer’s appraiser and the sales comparison approach by the assessor’s appraiser. The court accepted the sales comparison approach noting the following:

There is a common thread that appears to establish a market for the sale of retail power centers when considering Lowe’s, BJ’s and Home Depot stores. This thread comes into play from the construction of a freestanding retail power center building, the use of a long-
term lease to a retail power center and a subsequent purchase of the land and building by the same retail power center within a short period of time following the execution of the lease. These transactions show a pattern of operation for retail power centers: building a store, entering into a long-term lease and then outright purchasing the property in short order to become an owner-occupant.

B. DISTRICT OF COLUMBIA


Issues: long term lease, sale leaseback suspect as collusion

Taxpayer owned three of eight stores. It previously owned all, but sold five and leased them back under long term, NNN leases. The assessor valued all eight by the cost approach and did not develop an income capitalization approach. The taxpayer’s appeal was premised on a below market, long term lease. The taxpayer asserted that the assessor should have considered the lease in his valuation of the property. The court rejected the argument that the income approach was mandatory but that all three approaches must be considered but not necessarily completed so long as there was a reasonable explanation for rejecting an approach:

... Safeway may be correct that income capitalization is generally the best method for valuing income-producing business property, “because it is most similar to the analysis made by knowledgeable buyers before they purchase” such property. [Citations omitted]. Here, however, Safeway has not shown the reasons given for rejecting the income approach were irrational or unfounded...

Safeway argues, nonetheless, that the trial court improperly permitted the District assessors to ignore the impact of inexpensive, long term leases that effectively are encumbrances on the properties, reducing their resale market value...

If the current leases encumber the property, Safeway can hardly complain, for Safeway itself negotiated these leases. Moreover, Safeway’s very argument gives us confidence in sustaining the trial court’s approval of the assessor’s decisions to reject the leases as measures of property value. That argument confirms Safeway entered into the kind of inexpensive leaseback arrangement which, if permitted to determine the market value of the property, would allow owners to create artificial sale and leaseback arrangements solely to reduce their property tax obligations to the community. Because of that possibility, we believe the Department ...would be justified in adopting at least a presumption against recognizing such “encumbrances” in valuing leaseback property (especially where the lessee also pays the property tax)...

CVS Corporation v. Rob Turner, Consolidated Case Nos. 07-8515, 08-10799, 09-020997, 10-9490 (Fl.Cir.Ct. 2013); voluntary dismissal, 149 So.3d 10 (Fla.App.2 Dist 2014).

**Issues**: highest and best use, occupied vs. vacant stores, deed restrictions, cost approach; substitution

These consolidated cases involved both operating and abandoned CVS properties. The Taxpayer contended that the highest and best use of the stores was for general commercial use and not for use as drugstores. The taxpayer argued that sales and income information from bank branches, auto part stores and office buildings, etc. should be used to value functioning and abandoned drugstores.

For the abandoned stores, the assessor agreed that because of the deed restrictions and changed market demand, the highest and best use was for general commercial use but not the highest and best use for functioning stores. Functioning drugstores value should be based on market data from other similar functioning drugstores. The assessor testified that the migration of drugstores from former in-line locations to freestanding, traffic-lighted, corner locations coupled with the litigation brought by taxpayer’s competitor, Walgreens, prompted him to review the valuation of these freestanding drugstore properties.

In doing that, the assessor reviewed appraisals of drugstores done for purposes other than tax appeals. These appraisals concluded that the highest and best use was for continued use as drugstores; that the properties do not suffer functional or external obsolescence and the sales and lease rates of other freestanding drugstores are comparable.

The assessor used land sales not involving drugstores at traffic-lighted corners, The Marshall Valuation Service cost data and depreciation tables, and actual construction costs obtained from Walgreens as the basis for the development of the cost approach. For the sales comparison approach, abandoned stores were excluded because of deed restrictions that result in the underutilization of the improvements. The sales comparison approach established that the assessed values of nonfunctioning stores were 60% lower than the sales for functioning stores. For the income approach, contract rates of 20 CVS leases and numerous Walgreen leases were used to extrapolate market rent. The final assessed values were based on a blend of the cost and income approach.

The taxpayer put forth the testimony of two experts on methodology, neither of which had done many drugstore appraisal reports. The Court gave their testimony no weight other than noting that one admitted that if not for the deed restrictions, another drugstore could acquire and use the abandoned stores.

The trial court determines that the highest and best use of operating stores was as a drugstore:

... [T]he highest and best use of the operating drug stores and the proper appraisal approach to apply to these properties is the crux of the dispute between the parties. CVS’ conclusion as to the highest and best of the operating drug stores properties was for
“continued commercial use of the existing improvements, which is not solely specific to a retail drug store.” [citation omitted] Those uses would include restaurants, furniture stores, office buildings, used car lots, and branch banks, in addition to retail stores. [citation omitted] Therefore, CVS concludes that a buyer would pay the same for freestanding drug stores as they would for those types of properties. [citation omitted] Subsequently, those types of properties are used by CVS in the sales comparison and income approaches.

The evidence shows, however, that when a drug store property is converted to some of the secondary commercial uses described above, not only does the property have a legal restriction prohibiting use as a drug store, but the buyers also either renovated the properties or did not use all of the square footage. Those secondary general commercial uses are not the highest and best use of the currently operating drug store properties. CVS’ appraiser also acknowledged that it would be reasonable to conclude that the maximally productive use of these properties would be for drug store use. [citation omitted] . . .

The court adopted the cost approach because it avoided the issue of leases in place and functioning stores do not suffer from unusual wear and tear, functional or external obsolescence. It was noted that CVS weighs the costs and benefits of building their own stores when it comes to the decision to acquire an existing store or chain of stores:

The Court found the cost approach is a logical appraisal method to apply to the currently operating stores. These properties suffer little in the way of physical depreciation, functional obsolescence or external obsolescence. That, according to The Appraisal of Real Estate, 13th edition, makes the property a prime candidate for the cost approach:

The approach is especially persuasive when land value is well supported and the improvements are new or suffer only minor depreciation and, therefore, approximate the ideal improvement that is the highest and best use of the land as though vacant.

D. IDAHO


Issues: as-if-vacant; limited market special use property; hypothetical buyer; cost approach

The local level court upheld the assessor’s valuation of a regional warehouse/distribution center with a two-bay truck-washing building, fueling station, guard house, truck scale, warehouse space, office space and truck terminal wing with 59 dock doors. The chronological age of the improvements at the time the decision was rendered was seven years.

The taxpayer argued that the property had a limited market. The appraisal presented by the taxpayer was based on a hypothetical assumption that the property was vacant and available for sale. Taxpayer argued that the main question to ask was “who would buy the property if the taxpayer vacated?”
The court rejected the argument that the property should be valued as-if-vacant:

. . . Appellant . . . argues an “assumption of vacancy” in support of the obsolescence. This in effect suggests the question, what would the subject property sell for if ShopKo were not in the market place. Some appraisals required by banks may specify a quick-sale valuation under a vacancy assumption, however for Idaho’s ad valorem assessment system we find this position totally without legal merit or other foundation. It is in fact contrary to . . . the undisputed facts of this case. The subject was a large operating warehouse/distribution facility on January 1 and we see no reason to assume otherwise.

The Board’s response to the assessor’s cost approach:

It is perhaps somewhat unusual for a large commercial/industrial type facility to suffer from little-to-no functional or economic obsolescence. However, this appears to be just the circumstance in this case. The subject property is a relatively new facility and is being used as planned by the owner for a rather specialized purpose. There was no expression by either party that the subject property was providing any difficulties for the current user . . . In considering all of the information presented and otherwise available to the Board, we feel the cost approach is the most reliable indicator of value for this owner-occupied property . . . .

E. INDIANA


Issues: sale leaseback; personal property

This case is cited in the Prieb, infra [Kansas] as support for the conclusion that build-to-suit rents de facto cannot reflect market rent without adjustments for financing considerations.

The property sold with 16 other cinemas and then was leased back. The taxpayer expert testified that the use of sale-leasebacks were prevalent in the cinema industry as financing tools and often included personal property. He also asserted that “as a rule of thumb,” rent in the industry was approximately 11.5% of gross revenue and the rate in this lease was 27%; thus, it must have included more than rent for the real property.

The assessor asserted that because leaseback transactions were the norm in the industry, the sale-leaseback of the property was the most reliable indicator of value. He compared the sale price of the property to six other cinemas sold throughout the country to establish that the sale allocation for the property was reasonable; but he also admitted that the contract rent probably included more than the value of the real property.

The Board adopted the value of the taxpayer stating that the evidence showed the contract rent was significantly higher than the industry standard and that the industry rents included personal property financing. Also, there was no evidence to explain how the sale price was allocated to the subject.

Issues: corporate headquarters; highest and best use; hypothetical buyer; cost approach; special use properties

This case does an extensive analysis of decisions in other jurisdictions, so it is a good source as reference also for additional cases.

The property is a large, state-of-the-art, LEED certified corporate headquarters in Des Moines, Iowa built in 2010 for $150,000,000. It is five stories with a two-level, underground parking garage and surface parking. It is an architecturally distinct building, constructed with high quality materials. The property includes the type of amenities one may find in a specialized corporate headquarters, such as a convenience store, an art gallery, and a full-service restaurant.

The taxpayer presented two expert witnesses and the assessor presented two expert witnesses. The valuation indications were widely divergent. Essentially, the taxpayer’s experts appraised the building for less than half of what it cost to build it. The taxpayer claimed there would be no viable buyer for such a corporate headquarters building in Des Moines, and that a prospective (hypothetical) buyer would likely convert the property to a multi-tenant office building. As support for this stance, the taxpayer identified sales of ordinary multi-tenant office buildings as comparison to the property.

The assessor, on the other hand, argued that the current use is the highest and best use of the property and he ascribed a conservative taxable value of $99,000,000 for the property, an amount that was not only substantially lower than the cost to construct the building, but also a figure that was lower than the assessor’s own experts’ opinions. The Board of Revision upheld the assessor’s value. The taxpayer appealed.

In the appeal, the trial court de novo concluded that the cost approach provided a more reliable indication of value than the other approaches to value. The assessor’s value was upheld:

... we conclude that the $99 million valuation of the building is supported by the record. We embrace the view that the property should be valued based on its current use. That is the principle articulated in Maytag and Soifer, where we valued a large manufacturing concern and a franchised restaurant. In those cases, we resisted efforts by the taxpayers to depart from their current use in the valuation of their property. We decline to employ a use other than current use here as well.

Our approach does not incorporate the value of prohibited intangibles into the appraisal. Although the legislature has prohibited consideration of special value and good will, we have narrowly construed these exceptions. [Citation omitted.] If improvements to a property are not merely valuable to the specific owner but would be of value to others, such improvements should be recognized in the valuation process... the office space and
improvements on the Wellmark property “could readily be used by any large enterprise
desiring to house its home office under one roof” . . .

. . .the market for the Wellmark property for use as a single-tenant, office building may be
limited. But we think the fact that the property is currently being successfully used as a
single-tenant, corporate headquarters cannot go unnoticed. Current use is an indicator that
there is demand for such a structure. [Citation omitted.] While no specific potential buyer
has been identified, we do not think there has been a showing of no market, but only of no
active market. We adopt the view of other jurisdictions that under the circumstances, value
should be based on the presumed existence of a hypothetical buyer at its current use.
[Citation omitted.]

Further, we find it ironic that the taxpayer, having expended more than $150 million on its
new corporate headquarters, now urges that the property is worth less than half of that
amount for tax purposes. As noted by one court, “[g]iven a profit-minded owner with
available experience and resources, and a competent builder, the cost of construction is
likely to represent the value of the newly-finished product.” [Citations omitted.] We further
note that under the approach advocated by Wellmark, very expensive and costly properties
such as large manufacturing concerns could escape fair taxation on the ground of lack of a
local market for a specific use.

. . . we conclude that the cost approach provides the best mechanism for determining
market value. There is no dispute that the building is appropriate as a corporate
headquarters for an insurance company. There is also no dispute that the actual cost of the
building was in the neighborhood of $150 million and that there had been very little
physical deterioration of the structure as of the date of the assessment. Courts have often
applied the cost approach in determining the value of a single-tenant, corporate
headquarters property when comparable sales were not available. [Citations omitted]. . .

. . . to overcome the Board's assessment, we must be convinced that substantial functional
obsolescence occurred on the day that the doors of the building opened. As in Bankers Life,
where the Board valued the property with a twenty-four percent obsolescence factor, we do
not think any reasonable depreciation of this new building can bring the value below the
$99 million established by the Board. [Citation omitted].

G. KANSAS


Issue: build-to-suit leases

The property was a Best Buy located in the prime commercial market of the capital city. The
lease was entered into in 1996 for a term of 15 years that required the lessor to construct an
expansion on the existing building. It is not clear if Best Buy already occupied the building.
The County’s appraiser used build-to-suit leases for a market rent determination. The appraiser did not have a copy of the leases. The issue was raised that these are financing arrangements and may include the financing of personal property. The board of tax appeals used the appraiser’s income approach, but substituted a rental rate for a so-called build-to-suit second-generation lease.

The court of appeals held that build-to-suit leases are de facto financing arrangements and do not reflect market rent without a “disentanglement” of the financial considerations.


Issues: corporate headquarters; as-if-vacant; leasing commissions

The property was an owner occupied corporate headquarters. The taxpayer argued that the property should be valued as-if-vacant and available for lease because the owner will vacate on the hypothetical sale date. In the income approach, the taxpayer’s expert deducted leasing commissions from below the line:

In order for a lease-up discount to be a viable part of an appraisal, the highest and best use of a property must involve leasing. Because a lease-up discount calculates the expense to a new owner to bring the property from vacant to a stabilized occupancy rate by leasing to new tenants, it obviously does not apply to a property for which the highest and best use would not involve leasing to tenants at all. COTA found that the highest and best use of this property was as an owner-occupied facility. An owner-occupied facility does not involve leasing and therefore does not implicate a lease-up discount.

H. KENTUCKY

Wilgreens, LLC v. O’Neill, 2016 WL 5319593 (KY Ct. App.) The opinion is noted as not final, but no appeal is noted in the history.

Issues: as-if-vacant; market rent, intangible value

The property was developed by an independent third party to the specifications of Walgreens for a new drugstore but Walgreens was not a party to the construction agreement. Under the lease, the developer/owner financed construction and Walgreens leased the premises NNN for 25 years with 5 five year renewals. The rent payments did not increase over the life of the lease terms. The lease also gave Walgreens right of first refusal to purchase the property outright in the event the developer/owner decided to sell.

As soon as Walgreens moved in, the developer/owner listed the property in the NNN market. A buyer, Wilgreens, offered to buy the property for $6,275,000. Walgreens elected not to exercise its right of first refusal. The sale price was the assessed value for 2007, 2008 and 2009. Walgreens appealed asserting a value of $3.9 for all three years. A stipulation was reached for $5,250,000, $5,250,000 and $5,086,000 under which Walgreens concurred that the income approach was the proper method for valuing the property.
In the years 2010, 2011, 2012 and 2013, the property continued to be assessed at $5,086,000, but Walgreens appealed asserting $4,397,600 for these years. Testimony stated that the rent payments were based on the total costs of development. Testimony also stated that Walgreens does not vacate a store unless it is an unprofitable location. When that occurs, Walgreens subleases to second-generation tenants such as dollar stores, auto parts dealers and Goodwill. Testimony also was that Walgreen rents were between $24 and $28 per square foot and second-generation subleases between $8 and $15 per square foot.

Walgreen asserted the rent it pays is “never market rent because it is never on the market.” Walgreens asserted that if the goal is to value the fee simple, only market rents in the locality may be considered and any increment of rent paid by Walgreens above market is non-real property.

What resulted was that the court rejected the assertion of the expert who:

. . . believes to properly value properties like Walgreens the appraiser “has to suspend reality” and understand the way the property with the lease is being bought and sold is not reflective of the property’s value in fee simple. . .

. . . Walgreens has repeatedly focused its attention on the fact that the rents it usually agrees to pay are “above market.” Walgreens attempted to show this property was overvalued by relying on properties very different from the present.

. . . To interpret the tax assessment statute as requiring valuation of property in a hypothetical unencumbered form ignores the economic realities of commercial real estate transactions . . .

The court determined that the assessor did not distort the value of the property by using the lease in place. The court further stated that the assessor is allowed to consider the benefits and advantages that arise from property ownership such as the present value of the rental income.

The assessor successfully proved that the desirable location was one of the reasons that the property was worth more than other properties in inferior locations.

I. MASSACHUSETTS


**Issues**: sale leaseback; long term lease; restricted rents

The property was a warehouse distribution center with an office. The owner sold the property in 1957 and simultaneously leased the property back. The lease was for 25 years with four 5-year renewals NNN. The original lease rate was $1.44 per square foot and decreased to $0.63 per square foot during the renewal periods. The property sold again during the first renewal term in 1983 for $310,000.
The assessor valued the property at $385,000 in 1982, $1,150,000 for 1983 and $1,253,000 for 1984. The taxpayer argued that the sale price provided the most reliable indication of value. The board acknowledged the existence of the economically unfavorable long-term lease but concluded value should be based on potential earning capacity. The decision of $991,800 was affirmed on appeal:

The company seeks to distinguish Donovan because in Donovan there was no actual sale. That distinction is immaterial. Donovan focuses on the nature of what is taxed, not on the method of valuation, noting that the real estate tax is a “tax upon the whole land and not merely on the interest of the persons taxed . . .

The use of actual rents is an acceptable method of valuation as long as they adequately reflect earning capacity. [Citation omitted]. There must be a relation to market rental value. [Citation omitted]. The company does not contend that the actual rents reflect earning capacity or market rental value. However, it argues that the fixed nature of the rental income in this case is an “economic reality” analogous to the restriction on renal income [citation omitted]. In that case we held that the board erred in not taking into account the restrictions place by federal regulations on the rent received from a housing project. However, we specifically stated that “we do not think the restrictions on the company’s housing project resemble a disadvantageous lease.” [Citation omitted]. [T]he existence of an outstanding lease at an unrealistically low rental for a long term, not representing the fair rental value of the property is not to be used as a basis for calculating actual value . . . .

J. MICHIGAN


Issues: intangible value; as-if-vacant; uniformity; market rent

The property was a combination of office and light industrial space. Each building was occupied and leased. The parties stipulated that the income approach was the appropriate valuation method. The taxpayer argued that the leases in place personal property, not real property, and that the intangible value of the leases be excluded. In the alternative, the real property should be valued as-if -vacant because the fee interest is separate from the leasehold interest. It also made an equal protection claim that consideration of lease rates penalizes good management and rewards poor management.

The value of the property based on existing leases, continued occupancy, and market rent was $18,161,260. The value of the property as-if-vacant and available for sale was purported to be $14,250,000.

The taxpayer’s assertion was rejected because a property would likely sell for more with the leases in place and consideration should be given to the leases for the determination of fair market value:
COMMERCIAL BIG-BOX RETAIL
A GUIDE TO MARKET BASED VALUATION

...[T]he income approach determines value on the basis of the income produced by the leased interest plus the value of the reversionary interest, i.e., the base value of the property itself in addition to its income-producing potential. Put another way, under the income approach to valuation, the true cash value of the property, or the value of the fee simple estate, equals the value of the leasehold interest plus the value of the reversionary interest. [citation omitted] Accepting petitioner’s argument that only the reversionary interest should be valued would result in an assessment below market value... 

Petitioner’s argument that the leasehold interest represents a personal, intangible asset that cannot be taken into account when determining the true cash value of property also fails... A lease has no value apart from the physical property to which it relates because the rights transferred are the rights to use or occupy the property. Consequently, a lease is not an intangible asset comparable to a patent or stock holding. [citation omitted]... the Supreme Court expressly held that intangibles may be taken into account where they influence the market value of the property. Therefore, even if the leases could be considered to be intangible property, they are properly “considered in the valuation and assessment process in the same manner as tax benefits, location, zoning and other intangible value influences [citations omitted]...” 

Petitioner also argues that taking the value of the leases into consideration violates the requirement of uniformity of taxation. The assertion is that a poorly managed property will have a lower lease rate than a property that is well managed and this will result in a lower tax base. That would, it is claimed, amount to a violation of the uniformity of taxation requirement as the well managed property would be taxed higher than an otherwise identical property that is poorly managed. The premise of this argument is flawed because, whether there is good or bad management, with its predictable effects on income, it is irrelevant to the income the property “can earn” or is “capable of earning.” This objective evaluation is the relevant question under the income approach... Accordingly, under the income approach, a poorly managed property, that is otherwise identical to another property that is well managed, should not have a different assessment because the assessor is to consider the income the poorly managed property “can earn” or is “capable of earning” [citation omitted] and is not to be derailed in this analysis by the lower income that is actually being earned as a result of poor management.


Issues: sale leaseback; arm’s length factors; long term lease

In 1969, JC Penney owned several parcels on which it built a department store that became part of a mall. In 1974, it sold the improvements and leased the land to Pennarbor. Simultaneously, Pennarbor leased the improvements and subleased the land to JC Penney. In 2004, JC Penney argued that the subject was overvalued by the use of market rents because the subject was encumbered by a long term, economically disadvantageous lease. They claimed the income...
approach should be based on the actual rents not market rents. The leases had an initial term and numerous renewals up to 2034 and/or 2049.

The court found for JC Penney based on the requirements of Michigan law, but it is the court’s analysis of the sale leaseback that is of interest: The court used a three-part test that relied on a federal case, *Frank Lyon Co. v. United States*, 435 US 561, 98 S.Ct. 1291, 55L.Ed.2d 550 (1978) to determine the intent of the parties to the agreement.

- Is it a two-party or multi-party transaction?

Pennarbor obtained a mortgage to finance its purchase from an unrelated third party indicating a legitimate transaction. The concern of a two-party transaction is collusion in the disguised as a lease to lessen a tax burden.

- Is there a tax-independent business or economic motive compelling the transaction?

JC Penney had a business motive to generate capital for its business operations. Pennarbor had a business motive in that it is an investment company and although the terms of the lease may be more beneficial to JC Penney if it exercises its option to purchase, it allowed Pennarbor to receive the greater of the amount under the rent schedule in the lease or the fair market value of the property as determined by an independent appraiser.

- Does the buyer-lessee retain significant and genuine attributes of a traditional lessor status?

Because Pennarbor is ultimately responsible for the payment of the mortgage, its capital is at stake, not that of JC Penney.

Based on fulfilling the three-part test, the court determined that the transaction was a lease, not a mortgage, which resulted in a long term, unfavorable below market rent that a purchaser would consider, thus the actual rents should be considered.


**Issues:** as-if-vacant; highest and best use; build-to-suit; super adequacy; tenant improvements

This was a consolidated appeal of an operating Lowe’s home improvement store and an operating Home Depot home improvement store that presented a united front.

The taxpayers asserted the highest and best use was for “general retail.” The taxpayer’s expert rejected the use of build-to-suit sales and rents because he claimed the transactions were based on the cost to construct rather than supply and demand drivers from the market.

The taxpayer’s expert used vacant properties in the sales comparison approach and a mix of actual rents, build-to-suit rents and second-generation rents in the income capitalization approach. The
The taxpayer’s expert did a cost approach but regarded it as the least reliable approach of the three, claiming that substantial functional obsolescence attributable to the large size of these big-box stores is user specific, and that the special features for these stores are useless to a prospective buyer.

The assessor asserted the highest and best use was its current use as a “big-box” retail store. The assessor’s expert rejected sales of closed stores and used sale leaseback transactions, investor to investor sales, and landlord to tenant sales. The assessor’s expert also developed a cost approach to value the subject property.

The tax tribunal found in favor of the taxpayers, siding the owners’ assertions that the real properties should be valued as-if-vacant and available, even though both were operational stores. The Michigan tax tribunal accepted the taxpayer’s sales comparison approach as the most credible for a fee simple valuation of an owner-user property.

The court of appeals affirmed based on MCL 211.27 that requires consideration of the “present income” of “rented or leased” property as of the assessment date. The properties in this case are owner occupied and have no income stream to consider; thus, the sales comparison presented by the taxpayers was supported by the evidence:

Moreover, valuing the subject properties as vacant and available for sale, as opposed to occupied, constituted a proper valuation of the fee simple interest. Because these properties were owner-occupied at the time of assessment and because MCL 211.27(1) requires that TCV be based upon the “usual selling price . . . at the time of assessment,” the interest to be valued was the fee simple interest, which is the value of the property when sold unencumbered, as opposed to the leased fee interest, which is the value of the property sold with a lease in place . . . Because a sale of the fee simple interest in a property means the property is sold without a lease in place, it is also sold without a tenant in place – i.e., unoccupied . . .


**Issues:** deed restrictions; cost approach

The Michigan Tax Court followed the same rationale as in the above referenced case with Lowes/Home Depot, but this time the Michigan court of appeals remanded the case and ordered the lower court to consider the cost approach.

In this matter, it was brought out that the comparable properties used by the taxpayer’s expert had deed restrictions that prohibited the properties from being used for the purpose for which they had been designed. Both parties agreed that the highest and best use of the property was as an owner-occupied freestanding retail building, and that the taxpayer’s sale comparison approach did not value the property at its highest and best use:
There was no evidence in the record of any deficiency in the subject premises that would inhibit its ability to properly function as an owner-occupied freestanding retail building. The functional obsolescence to which Menard refers appears to be the fact that, due at least in part to self-imposed deed restrictions that prohibit competition, such freestanding retail buildings are rarely bought and sold on the market for the use as such but are instead sold to and bought by secondary users who are required to invest substantially in the buildings to convert them into other uses, such as industrial use. However as stated in Clark to read MCL 211.27 “as requiring the taxing unit to prove an actual (emphasis court) market for a property’s existing use would lead to absurd undervaluation.” [citation omitted] Therefore, the tribunal erred by failing to consider evidence under the cost-less-depreciation approach.

Not surprisingly the taxpayer asked leave to appeal to the Michigan Supreme Court, which is pending.

K. MISSOURI


Issues: long term lease; uniformity

The owner leased property to K-Mart since 1967. The initial term was 20 years with three 5-year options. At the time of appeal, K-Mart was in the middle of the first option. The only evidence of value was by the taxpayer’s expert who asserted the value of the real property, unencumbered by the lease, was $3,125,000, but subject to the unfavorable lease, the value was only $1,092,000.

The Missouri Tax Commission held that actual rent may not be considered a sole factor in determining value when relying on the income approach. The Commission further declared that considering the effect of a long-term lease violated uniformity. However, the Missouri Supreme Court overturned the decision and found in favor of the taxpayer because the assessor did not provide any evidence for a different value:

... Merely because a factor exists which impacts on the value of one piece of property that does not affect every other property in the same class is not a basis for violation of the uniformity clause. ...

The court reviewed numerous decisions in other states noting that there was no true consensus on the issue of long term leases. The court concluded that the better approach was to consider the actual and the potential income. The court noted that a long-term lease can be value enhancing or value reducing, so if the lease was prudent when entered into, it is appropriate to consider the actual rent as a factor in determining the value under the income approach.

The court did not give any guidance about how to determine if a lease negotiated 25 years earlier was prudent at the time.
**STL 400 N. 4th LLC v. Bushmeyer, 2005 WL 1121344 (Mo. Tax Comm’n).**

**Issues:** as-if-vacant; intangible value

The property was a mixed-use apartment, office and retail on two parcels with a common parking garage. The improvements were on a ground lease. In determining the value of the improvements, the taxpayer asserted that the leases in place were intangible value not attributable to the real estate and must be discounted in order to value the real estate as-if-vacant and available. To this end the appraiser deducted 6% of the total property valuation for intangible value.

The commission rejected the argument.

It is understood that in point of fact the purchase price of a vacant apartment or office building would most likely be at less than the same building with tenants. It only stands to reason that the same property would command more in a sale where it has leases in force, than if it were totally vacant. However, there are several points which present problems with this deduction.

First, as testified to by . . . “if I were to sell just the real property, which doesn’t happen because you don’t have a vacant apartment complex sell, . . . [citation omitted]. Since, this is a hypothetical that doesn’t happen, its application to ad valorem tax valuations is extremely limited, if not non-existence [sic]. Second, [citation omitted], the existence of a lease or leases is a matter which must be taken into account. We take the property as it exists in appeals before the Commission because that is the condition which the prospective hypothetical investor will take the property. Third, if the market does not provide a basis for the adjustment, then it cannot be supported, and it is not warranted. [Citation omitted]

**L. NEW JERSEY**


**Issues:** business intangible value; tenant improvements; cost approach – entrepreneurial profit intangible value

The property was a super regional shopping mall. The taxpayer challenged the assessments of its first three years of it operation, 1976, 1977 and 1978. The mall was substantially completed in October 1976. The parties agreed that the current use of the property was its highest and best use.

The taxpayer’s primary arguments:

1. Much of the value of the mall is attributable to the owner’s extremely good management (intangible value). The court rejects the argument:

   It is true that less income (and thus less value) would result if the same amount of square footage were leased to tenants of less diversity and lesser quality than plaintiff’s and if a
markedly less extensive merchandising effort were undertaken than exists at Quaker Bridge Mall. It is also undoubtedly true that decisions made by plaintiff regarding the size, configuration and overall design of the shopping center have led to enhanced rents, as plaintiff hoped they would. However, it is also beyond dispute that management expertise generally varies from property to property throughout any taxing district and that fundamental appraisal principles deal with these disparities.

The first such principle is that a property must be valued at its highest, best and most profitable use [citations omitted] The parties in this case accept the premise that a super regional shopping center is the highest, best and most profitable use of the subject property. Expert management of the kind provided by plaintiff is essential to such a sophisticated use. If the income potential of Quaker Bridge Mall were not being realized as a result of inadequate management the court might well have to adjust for this by adding a factor to the actual or contract rents received from plaintiff’s tenants. This involves a second fundamental appraisal principle: that “economic” rent or income must be used in the capitalized income approach to the valuation of property if economic rent differs from actual rent. [citations omitted]

A finding of economic rent is dependent on the proofs adduced by the experts. [citation omitted] If a finding could be made that a particular property generates a level of extraordinary income from extraordinary management such that the capitalized stream of the income is indicative of more than the value of the real property, the finding would have to be based on an analysis or the property’s actual income contrasted with economic rent for comparable properties. For this reason there could be no preliminary finding that some portion of Quaker Bridge Mall income is enhanced rent that must be discounted in the income approach on the grounds that it is reflective of plaintiff’s business acumen rather than the value of the subject property . . .

2. The improvements to the shell space are the personal property of the tenant and not taxable as real property. The court declines to consider tenant improvements as personal property to be piecemealed from the value:

It simply cannot be ignored that the improvements made by the Mall tenants created finished space that was more valuable income property than was the series of concrete shells plaintiff leased to its tenants . . . It may or may not be accurate, as argued by plaintiff, that the tenant finishes of one tenant were of no value to a succeeding tenant, but that is not relevant. The finishes added value to the Mall structure and that value must be recognized by the income approach. Furthermore, for the reasons advanced by defendant’s first expert, an income stream must be imputed to the tenant improvements in an effort to determine the value of the subject property at its highest and best use, not as a series of concrete shells.

3. Entrepreneurial profit cannot be not included in the cost approach as it is intangible business value. The court also rejected this argument:
One of the most significant disputes between the parties . . . involves the concept of “entrepreneurial profit.” Plaintiff contends that there is no such profit that may be valued for ad valorem tax purposes . . I am persuaded that entrepreneurial profit is a legitimate element of market value that must be measured . . As defendant argues, no prudent developer would produce a property . . and sell if for his actual cost of land acquisition and construction. The developer’s raison d’être is entrepreneurial profit.

*Riegel Products Corp. v. Milford Borough, 13 N.J. Tax 546, 562 (1994).*

**Issues:** hypothetical buyer, highest and best use; cost approach; circular reasoning; value-in-use

This case is referenced in the *CVS v. Rob Turner* case, *supra* [Florida].

The taxpayer appealed its 1990, 1991 and 1992 valuations. The property was used for paper manufacturing that required specific improvements. The taxpayer asserted that there was no market for the property and its highest and best use would be a secondary use of general manufacturing or warehouse. The taxpayer used various industrial sales of various sizes and uses and the used these sales to determine depreciation by market extraction.

The assessor asserted the highest and best use was its current use as a manufacturing plant for paper products. He claimed the sales comparison approach relied on by the taxpayer was inherently invalid because the comparable properties were not truly similar in any way to the subject and that the taxpayer’s depreciation adjustment in the cost approach was also unreliable.

The taxpayer countered that the use of the cost approach is a value-in-use, not market value, so it should not be relied on anyway.

The court, like in *Shopco, supra*, [Idaho] rejected the taxpayer’s sales comparison approach and relied on its cost approach, except for the functional obsolescence adjustment (that was based on circular reasoning) noting the plant ran three shifts, 24 hours a day and the taxpayer had just added new improvements. The court stated that the cost approach is not a value-in-use:

>*Use value focuses on the value real estate contributes to the enterprise of which it is a part, without regard to the property's highest and best use or the monetary amount that might be realized upon its sale.*[Citation omitted]. In this case, determination of market value of the subject must consider the value of its physical characteristics, *i.e.*, general heavy manufacturing, paper manufacturing and kindred uses and its other special real property features to a hypothetical purchaser who requires this type of property. Since I find that the present use of the subject is its highest and best use, my finding of value is based on market value in exchange to a hypothetical purchaser at the property's highest and best use, not its value-in-use. The inquiry is not with respect to the value of the property to the owner, but rather to its market value at its highest and best use regardless of who owns it.

**M. NEW YORK**

Issues: as-if-vacant; hypothetical sale, leasing commissions

The taxpayer asserted that an annual allowance for leasing commissions should be allowed on the 40% of space that it occupied as the owner. The taxpayer argued that the hypothetical buyer would have to lease the 40% of space vacated by the current owner in the hypothetical sale. The court rejected the argument.

... nor are we inclined to set a precedent, for classifying space which is, in effect, occupied (albeit by the owner, not a paying tenant) as vacant based on the fiction that it will be leased to a paying tenant at the start of each new tax year ... while owner-occupied space is calculated as if leased at market rent to produce a hypothetical revenue stream, the fact that it does not do so is entirely by Mutual’s own choice, and Mutual “cannot expect [its] fellow taxpayers to compensate [it] for the difference.”


Issues: second-generation rents

The taxpayer’s expert valued the real property using only vacant, older and lesser location stores in the sales comparison approach and only second-generation rents in the income capitalization approach. He asserted that build-to-suit leases were not accurate indicators of market value because the original user would pay more to build its prototype building than the market would be willing to pay. The taxpayer’s expert’s value was $4,600,000 to $4,800,000.

The assessor’s appraiser disagreed, stating that such leases were negotiated at arm’s length between a tenant and a developer motivated to maximize profits. Using build-to-suit sales and leases in the sales and income approaches produced a value estimate of $10,800,000 to $11,100,000. The assessed value was $8,967,069.

The taxpayer’s expert report was rejected by the trial court. The assessor’s value was sustained. The decision was affirmed on appeal noting that it was the trial court’s place to determine the credibility of the experts; but the appellate court made the following short and sweet pronouncement that was unnecessary to the decision; and thus, is telling:

Lest there be any uncertainty [sic] here, and “in the interest of judicial economy,” we exercise our broad authority to independently consider the evidence. [Citation omitted].

Considering the above, we find that the court properly dismissed the appeal.

N. NORTH CAROLINA

In re Lowe’s Home Centers, LLC, 13 PTC 904 (NC Property Tax Comm’n 2016).
Issues: as-if-vacant; cost approach

The taxpayer asserted that its real property should be valued as-if-vacant and available to lease and presented a sales comparison analysis using vacant properties, some with deed restrictions prohibiting the use for which the improvements were designed. The Commission affirmed the county’s cost approach valuation.

In this case, Lowe’s expert’s analysis, under the sales comparison approach failed to establish the market value for the Subject Property as of the Valuation Date when his comparable sales prohibit the uses consistent with the highest and best use of the Subject Property because: (a) all of the comparable sales were all located outside of North Carolina, and were not adjusted for the difference in economic markets; (b) all comparable sales were inferior to the Subject Property since the sales consisted of former closed Wal-Mart and Target stores with no adjustments or consideration for the change in the economic and market conditions that caused the store closings; and (c) the comparable sales were closed, second-generation, discount stores, that had deed restrictions prohibiting the uses consistent with the highest and best use of the Subject Property.

O. OHIO


Issues: corporate headquarters; sale leaseback

Taxpayer testified that a balloon payment was due on the original mortgage for the construction of its office building. The amount of the balloon payment, when it was due and when it was paid are not noted.

Taxpayer solicited offers but how that was done is not provided. There is no indication that bidders knew of the balloon payment. Bidders would have likely used that information to deflate the purchase price. That fact definitely would not have increase the amount the buyers were willing to offer. Four or five offers were received and the highest offer fell through because the buyer wanted to be a mortgage holder. The next highest bid was accepted. The rent amount was based on the purchase price but the rent amount was not specified. There was no evidence noted that it was below, at or above market. There was no indication that the taxpayer and the buyer were related parties. There was no indication if there was transfer of title back to the seller at the end of the lease term or an option to purchase. It was also unknown if the buyer financed the purchase or if it was all cash up front.

The assessed value was $8,326,400. Both the board of education and the city of Strongsville filed to have the assessed value raised to $9,500,000 based on an appraisal. The sale occurred while the matter was pending and the city sought to amend its original petition and filed for the following year asking for the sale price of $16,000,000.
The Board declined to use the sale price but did adopt the request for $9,500,000. The rejection of the sale-leaseback as not a valid sale is based on uncorroborated and uncontested taxpayer testimony that is self-serving. The decision is affirmed on appeal because the taxpayer’s testimony was uncontested.


**Issues:** sale-leaseback

The property was an operational Applebee’s restaurant. Taxpayer asserted the sale was a lease back that was not an arm’s length, open-market transaction. The taxpayer argued a sale-leaseback makes the subsequent sale price not indicative of true value.

The previous owner purchased the property in an aggregate sale and leased it and the other properties back to Applebee’s. It then sold the properties individually with the leases in place.

The lease for the property was 20 years with four 5-year renewals and a right to first refusal that it did not exercise. The taxpayer purchased the property for $2,788,658. It was valued at $896,040 and the school board filed a complaint requesting the sale price be adopted. The school board prevailed and the taxpayer appealed. The decision is affirmed.

. . . [T]he sale leaseback in this case constitutes . . . an arm’s length transaction. . . . the taxpayer admitted that the parties to the sale leaseback were unrelated. Each manifestly pursued its objective to obtain maximum value from the real property interests in the transaction . . . Apple American sought to realize the value of the fee interest by selling the real property to obtain operating capital . . . Preco sought to realize value from purchasing the fee interest by encumbering the property with a lease that provided a stream of rent income - income that would allow Preco to sell the property at a premium in the net-lease market. The fact that the rent rose in accordance with the amount of cash “financing” that Apple desired does not mean that the sale leaseback, taken as a whole, is anything but an arm’s length transaction.

_CCleveland OH Realty I, LLC v. Cuyahoga Cty. Bd. of Revision_, 121 Ohio St.3d 253, 903 N.E.2d 622 (OH 2009).

**Issues:** sale-leaseback

Revco Discount Drug Centers, Inc. acquired the property in 1999 and then sold it together with other properties as part of a sale leaseback in 2000 that obligated the parties to a long-term lease of 23 years with 10 renewals. Subsequently Revco was bought out by CVS who occupied the property when CCleveland purchased the property in 2004 for $4,084,750. Taxpayer argued the long-term lease elevated the purchase price and the lease was not an arm’s length transaction because it was a sale-leaseback. The court reaffirms _AEI, supra._

. . . [T]he “concern associated with sale leaseback transactions lies in collusion between the parties to depress property value for tax purposes. [Citation omitted]. Nothing in the
record of this case raises this concern; indeed, CCleveland’s central objection arises because the parties to the sale leaseback succeeded in maximizing the value of the realty: the seller received an elevated sale price and, as consideration, committed to paying the purchaser a stream of elevated lease payments, which in turn allowed the purchaser to fetch a greater sale price later on. . .


Issues: intangible value; value in exchange

In 2003, the taxpayer purchased a property leased by Walgreen for $4,375,000. The sale price was adopted as the value by the assessor for 2004. Taxpayer appealed asserting the long-term lease inflated the purchase price above market. The value was reduced by the Board of Revision to $1,950,000 based on an appraisal that discounted the lease. The assessor appealed and the Board is reversed for the following reasons:

1. The sale was an arm’s-length sale between a willing seller and a willing buyer.

2. An existence of an encumbrance does not prevent a recent, arm’s length sale price from reflecting true cash value.

3. The purchase price does not reflect any business interest of Walgreen as the taxpayer paid for a fee simple interest in property acquiring all the rights of that interest including the rights of the lessor and the rights to collect payments from Walgreens under the long-term lease. Although the lessee’s business may affect the value of the fee simple interest, the taxpayer did not purchase any interest in the lessee’s business.

4. A sale price is not a reflection of value-in-use; but is a value in exchange.

5. It is not relevant if the sale price exceeds the value of the property to the extent it exceeds what the buyer would pay to construct a similar property.

6. It is not relevant if the lease was a financing arrangement in lieu of a mortgage as there is no indication that the developer and Walgreen were not typically motivated market participants that sought to pursue their own financial interests.

The third point is the concept of intangible value enhancement to the real property. The credit worthiness of the tenant can and should be considered in the development of fair market value in the same way that location can and should be considered in the development of fair market value.

The sixth point clearly exposes the hypocrisy that build-to-suit leases are some sort of creative financing and do not reflect market value.

Meijer Stores LP v. Franklin Co. Bd. of Revision, 122 Ohio St.3d 447,452-454, 912 N.E.2d 560, reconsideration denied, 123 Ohio St.3d 1426, 914 N.E.2d 1066 (2009).
Issues: hypothetical market; highest and best use; second-generation; external obsolescence

Taxpayer sought to reverse the decision of the Ohio Board of Tax Appeals that adopted the appraisal presented by the school board. The school board’s expert looked to the taxpayer’s own use for determining market rent and comparable sales. When the expert was asked “who would rent the store,” he answered the taxpayer and accordingly market rent was what the taxpayer would pay if he did not own the building. For comparable sales, the expert looked to sales by developers who built big-box retail facilities on a build-to-suit basis for the tenant and then sold properties subject to the leases to third parties.

On appeal, the taxpayer argued that its value should not be based on properties subject to long term leases that are favorable to the owner because that is a leased fee not a fee simple value. The taxpayer additionally argued that this results in a value-in-use appraisal. The taxpayer used only second-generation purchasers and tenants to determine value by the sales and income approaches. Several of the sales were vacated by Kmart during its bankruptcy, two more stores also abandoned during bankruptcy, a Walmart abandoned for a new “super” center and a vacated Sam’s Club. Build-to-suit leases were deliberately excluded because the rents were purported to reflect value other than market rent. The court rejected these arguments:

Although Meijer’s property is currently not encumbered with a lease, Meijer’s contention that its property cannot be compared to build-to-suit properties is mistaken. As recent cases have demonstrated, the possibility of encumbering a property like the one at issue here constitutes – as a purely factual matter – one method of realizing the value of legal ownership of the property. [Citations omitted]. It follows that an appraiser when determining the value of Meijer’s store may take into account the possibility that at some point, the store could be held as a rental property . . .

. . . [T]he 1996 Meijer case . . . raised arguments similar to those advanced in this case . . the BTA . . . declined to adopt the larger amount of obsolescence found by the owner’s appraiser. The BTA had found “nothing about the present property which is obsolete or useless to the owner . . . a prospective purchaser [would] pay at least the costs of the property as newly constructed . . .

Taxpayer also asserted external obsolescence because the structure would not be easily adaptable to the needs of a potential buyer due to its size and that it may be demolished for redevelopment. The improvements were new.

. . . the present use of a property may be considered when “a building in good condition [is] being used currently and for the foreseeable future for the unique purpose for which it was built,” otherwise, “the owner of a distinctive, but yet highly useful, building [would be able] to escape full property tax liability.


Issues: economic obsolescence; second-generation
Taxpayer appealed its 2006 valuation of $8,188,290 asserting a value of $4,500,000. The taxpayer’s appraiser asserted that the highest and best use as improved was “continued discount storeroom;” but the “improvements have significant obsolescence that is typical of most big-box developments” that “results in a market value which is significantly less than replacement cost less physical depreciation.” Even brand new big-boxes are worth less than the cost to construct. The appraiser used only second-generation sales and rents.

The board of revision reduced the value somewhat, but the Board of Tax Appeals, on appeal by Target, concluded there was no evidence in the record put forth by the assessor to come to a different conclusion from that of the taxpayer. The assessor appealed arguing the property was special purpose as a fall back for failing to provide any evidence to contradict the taxpayer’s appraisal by citing to *Meijer, supra*. The court refused to apply *Meijer* because the county failed to provide evidence to support its value and contradict the taxpayer’s evidence.


**Issue**: sale-leaseback

The property was a fast food restaurant. Baker owned the real property and Setla operated the restaurant under a lease agreement. Setla negotiated a purchase of the property from Baker and entered into a sale leaseback transaction with Kaufmann for $675,000. Setla would lease the property for 20 years with four 5-year options NNN. The assessed value was $216,800 and the school board filed a complaint asking for $675,000.

While the appeal was pending, Setla filed for bankruptcy. Through the bankruptcy, Checkers assumed Setla’s lease obligations. Taxpayer argued the sale-leaseback was a financing transaction. Taxpayer argued the parties were related because Setla leased another property from Kaufman and Setla directly contacted Kaufman to purchase the property because of the landlord-tenant relationship. Kaufman needed to make a 1031 exchange and Setla needed to obtain operating capital. The board of tax appeals concluded it was valid sale and taxpayer appealed. The court affirmed:

An arm’s-length transaction has three primary characteristics: (1) it is voluntary; (2) it takes place on the open market; and (3) the parties act in their own self-interest. . . .

“. . . [R]elated parties may be pursuing the identical interest of common owners rather than acting as separately interested, typically motivated actors in the marketplace.” [Citation omitted]. . . .

. . . [E]vidence in the record demonstrates each party . . . was acting in its own self-interest and seeking to maximize the value it received from the transaction . . .

. . . [W]hile an arm’s-length transaction generally occurs on the open market, “[t]he case law does not condition character of a sale as an arm’s-length transaction on whether the property was advertised for sale or was exposed to a broad range of potential buyers.”
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[Citation omitted]. . . “private sales” which established that the absence of open-market elements did not necessarily negate the arm’s-length nature of a transaction. [Citation omitted]. . . evidence in the record support . . . that the . . . sale and leaseback transaction was an arm’s-length transaction . . . the . . . sale may have been analogous to a “private sale” because there is no evidence that the property was made available for sale to anyone other than Kaufmann, we conclude that the absence of open-market elements does not negate the other indicia that this was an arm’s-length transaction. . . .


Issues: sale-leaseback

Owner decided to sell three of its properties. The owner leased the properties to a related entity that operated preschools. The owner hired a broker who marketed the properties nationally. The owner referred the broker to the buyer. The owner and buyer are not related parties. The buyer then entered into a 15-year lease with the tenant at the same lease rate as it had been paying to the owner. The rent rate with the owner had not been based on market but established for internal purposes. The sale price was based on a negotiated capitalization rate. The agreed to capitalization rate was applied to the potential gross income generated by the rent rate for a sale price.

The original value of the assessor was $1,535,400. The school district sought to increase the assessed value to the sale price of $2,689,642. The buyer argued that the sale price was inflated because it was a sale-leaseback transaction. The buyer claimed that the fair market value was really only $1,600,000. The board adopted the sale price.

During the pendency of the appeal, there was an amendment to the controlling statute that changed the mandate that the assessor “shall” consider the sale price to “may” consider the sale price. The prior version of “shall” control, but it is unlikely the outcome of the decision would have been affected.

The buyer did not dispute that the sale was recent and at arm’s-length. The school district cited to HIN, L.L.C. v. Cuyahoga Cty. Bd. Of Revision, 138 Ohio St.3d 223, 2014-Ohio-523, 5 N.E.3d 637 (2014) as directly on point. The court agreed with the school district.

In HIN, the owner of an office building. in 2003, contracted with U.S. Bank for it to buy the property and US Bank assigned its purchasing rights to JBK Properties, Inc. JBK purchased the property for $4.9 million and then leased it to U.S. Bank. JBK and U.S. Bank signed a NNN lease. In 2004, JBK sold the property to HIN for $7.4 million. HIN argued the sale price was not fair market value because it sold with a lease encumbrance. The argument was rejected:

The only way a party can show that a sale price is not representative of value is to show that the sale was either not recent or not an arm's-length transaction . . .

. . . In Berea. [citation omitted], we faced the question of how to value a property subject to two long term leases. The property had recently been sold in an arm's-length
transaction. The board of education argued that the BTA should have disregarded the sale price and valued the property as if unencumbered with the leases. The board also presented appraisal evidence of what that unencumbered value would be. We rejected the board's arguments and held that when there has been a recent arm's-length sale, the taxing authority must disregard appraisal evidence and accept the sale price as the true tax value of the property, regardless of any lease encumbrances. Thus, despite HIN's contentions, a recent arm's-length sale price establishes the value of real property for tax purposes even if that property is encumbered by a long-term lease. See also AEI Net Lease Income & Growth Fund v. Erie Cty. Bd. of Revision, 119 Ohio St.3d 563, 2008-Ohio-5203, 895 N.E.2d 830, ¶ 17 (“we reject the contention that the existence of a long term lease resulting from a sale leaseback makes the subsequent sale price not indicative of true value”); Cummins, 117 Ohio St.3d 516, 2008-Ohio-1473, 885 N.E.2d 222, at ¶ 18 (“the arm's-length sale price of a legal fee interest should not be adjusted on account of the mere existence of an encumbrance” [emphasis sic]); Dublin City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision, 118 Ohio St.3d 45, 2008-Ohio-1588, 885 N.E.2d 934, ¶ 12 (same); Rhodes v. Hamilton Cty. Bd. of Revision, 117 Ohio St.3d 532, 2008-Ohio-1595, 885 N.E.2d 236, ¶ 3 (holding that a sale price established the tax value of property, even though the property was encumbered by a long-term lease).

P. TEXAS

Issues: as-if-vacant; fair market value means available for lease; small pool of buyers.


The taxpayer used one appraiser for an opinion and two on methodology. Their opinions were based on vacant big-box properties. The assessor used occupied big-box properties.

Texas law presumes the highest and best use is the current use. Comparable properties must reflect the same or similar highest and best use. The leasehold value is subsumed within the fee simple. It is appropriate to consider leased fee comparable properties. Occupancy is one of the factors to be considered.

The assessor’s values are sustained. This decision was rendered January 10, 2017. It is unknown if the decision has been appealed for trial.

Q. WISCONSIN


Issues: sale-leaseback; private sale

The property is a manufacturing facility and the operations had contaminated the ground water. There was a remediation program that required ongoing capital expenditures. In 1993, the property was sold and leased back. The sale was done by the parent company. The actual owner,
subsequently the tenant, was not involved in the decision to sell or in the negotiations of the sale price or the rent amount established for the leaseback.

The objective of the sale was to raise funds for the parent to retire debt and/or acquire new businesses. The parent hired an investment banker to find a buyer in the private capital markets. The sale price was fixed at $14,500,000 based on reconstruction costs new before depreciation. 95% of the sale would be obtained from a lender or lenders who would purchase notes from an equity investor secured by the property; the lease and a guarantee of the parent. 5% of the purchase price would be obtained from an equity investor whose bid would be couched on the terms of the rent it would require under the leaseback after considering the interest rate on the notes it would issue.

A private placement memorandum was sent to a number of institutional lenders. The bids were to be based on the amount of rent they would require to pay the fixed price. Four bids were received. The winning bidder required an absolute net rent, indemnification from contamination liability and a guarantee by the parent.

The Board concluded this was not an open market transaction, the sale price was not market value, the rents were not market rents and the seller was not a willing seller. The sale price and rents could only be achieved based on the guarantee.


Issues: intangible value

The property was a resort. Next to the resort were condominiums that were individually owned, but taxpayer received 50% of the rental income from the condos for providing a myriad of services including reservation and check-in, rental rate determination, advertising and marketing, maid service and the renters have full access to the resort amenities.

In 1996, the assessor included the rental income received by the resort in the development of the income approach. The assessed value was $8,500,000. The taxpayer challenged the assessment arguing the income was business value.

The assessor’s income approach was accepted by the tax commission and the circuit court and court of appeals affirmed the decisions. The taxpayer was unsuccessful with the Wisconsin supreme court.

"[I]ncome that is attributable to the land, rather than personal to the owner, is inextricably intertwined with the land and is thus transferrable to future purchasers of the land. This income may then be included in the land’s assessment . . . because it appertains to the land” . . .

As long as the potential to produce income exists with the land and transfers to a subsequent owner, whether a subsequent owner of the Abbey is able to maintain the same level of management income as ABKA has historically maintained is not central to our
concern. The relevance of a subsequent owner's success in maintaining the same level of income would be strictly limited to the specific amount included in the assessment. This amount may vary depending on the ability to exploit the income-producing capacity that inherently exists with the Abbey property.

A competent level of management can be expected to reproduce the predicted income stream from the condominiums. Most entrepreneurs willing to participate in the competitive resort market are likely to possess the requisite business savvy and skills to provide clean linens, switchboard services, and help with reservations and check-in and check-out. The services offered by ABKA do not suggest any unique skill on the part of ABKA, but rather militate in favor of finding a unique quality of the land itself that attracts prospective condominium renters.

Moreover, there is evidence that the assessor did indeed factor out the amount he believed to be attributable to ABKA's own labor and skill in management. He did this by including appropriate management fees as an expense of the resort in the stabilized operating statement. The remainder was properly included in the assessment as income attributable to the Abbey property and not to any unique skill on ABKA's part.

In summary, upon applying the test to determine whether business value may be included in a property tax assessment, we conclude today that ABKA's management income is inextricably intertwined with the Abbey. The management fees are generated both by and on the land on which the Abbey is located, and the ability to earn the fees is transferable to future purchasers of the Abbey. As value that is inextricably intertwined with the Abbey, the management income appertains to the Abbey.

See also, S Associates v. Bd. of Review, 164 Wis.2d 31, 473, N.W.2d 554 (Ct.App. 1991) (mall’s business of leasing space to tenants is a transferrable value inextricably linked to the land.) Waste Management v. Kenosha Co. Bd. of Review, 184 Wis.2d 541, 568, 516 N.W.2d 694 (1994) (income from landfill attributed to inherent capacity of the land to accept waste).

Nestle U.S.A., Inc. v. Dept. of Revenue, 331 Wis.2d 256, 278-279, 795 N.W.2d 46 (Wis. 2011).

Issues: special purpose; cost approach; highest and best use; hypothetical buyer

In 2001, Taxpayer completed construction of a powdered infant formula plant to meet rigorous Food and Drug Administration standards. The plant had numerous expensive features. The greatest net return would be the continued use as an infant formula plant by Nestle or one of its competitors. There had been no sales of infant formula plants in the United States. The assessor used the cost approach. No deductions for “super adequacy” were made to the cost approach because all the features were necessary for its continued use as an infant formula plant.

Taxpayer asserted that there was no market for an infant formula plant because one had never sold and thus, its highest and best use was a food processing plant. The taxpayer’s expert arrived at a value of $3,430,000 after deducting $13,895,020 for functional obsolescence in his cost approach.
The tax commission accepted the assessor’s valuation and the decision was upheld at the circuit court. The court of appeals affirmed the circuit court and taxpayer filed for review by the Wisconsin supreme court. The taxpayer was not successful:

The taxpayer’s argument that the Commission found there is no market for the Gateway Plant as a powdered infant formula production facility attempts to create a new requirement in our case law where actual sales must be identified when determining a subject property's highest and best use.

The purpose in requiring that assessors determine a subject property's highest and best use is to ascertain a property's “greatest net return to the property owner.” . . . the Legislature and this court have concluded it is improper to assess a taxpayer's property at a value that does not equate to what that taxpayer would receive for their property on the open market. This objective to determine a subject property's fair market value, however, does not require actual sales of other properties to be identified. A market can exist for a subject property, especially a special-use property, without actual sales data of similar properties being available . . .

The taxpayer’s “actual sales” interpretation would always force assessors to look for active markets when determining a property's highest and best use, even if the subject property already operated in a thriving, albeit limited, industry. This requirement would result in subject properties in limited markets being assessed, not at their fair market value, but rather at a value based on the subject properties' costly and hypothetical conversions to alternative uses.

*Walgreen Co. v. City of Madison*, 311 Wis.2d 158, 164-165 752 N.W. 2d 687 (2008).

**Issues:** build-to-suit; prevalent in the market

*Prieb. supra,* [Kansas] cites to this case as support that a build-to-suit lease is “creative” financing, but the specific facts presented here do not support the de facto conclusion in *Prieb*. This case received negative treatment in *Great Lakes, infra*.

Taxpayer leased the property for 20 years with numerous renewals up to 60 years. The property was built by a developer pursuant to a uniform business model of Walgreens. The developer found a site at prime locations in heavily trafficked areas, bought out the current owner or owners, demolished existing structures, and built a new drugstore.

The City conceded that the rent payments were above market because the rent was based on all of the costs of acquisition and construction including super adequacies and excessive developer’s profit. The super adequacies were not specified and the excessive developer’s profit is not substantiated. The City did not put on any evidence of market rent for this highly desirable location, but relied on the contract rent. The trial court agreed with the City. Walgreen appealed and the decision is reversed by the supreme court.
Because of the City’s concessions, it was presumed by the reviewing court that the build-to-suit lease was a financing mechanism and not “typical of normal financing and payment arrangements prevalent in the market.” Because the City put on no evidence of market rent, the only evidence of rent as a result was second-generation rents presented by Walgreen.

Great Lakes Quick Lube LP v. City of Milwaukee, 331 Wis.2d 137, 154-155, 794 N.W.2d 510 (Wis. 2010).

Issues: sale-leasebacks; prevalent market; uniformity

The properties are Valvoline Instant Oil Change operating businesses. In September 2004, in an asset purchase agreement, Great Lakes and three others agreed to purchase 29 parcels owned by Valvoline and 18 parcels leased by it and to allocate the purchase price of $26,000,000 among the parcels. The agreement required the parties not to take any position contrary to the terms of the agreement. The sellers and Great Lakes are unrelated parties.

On November 9, 2004, Great Lake assigned its right to purchase the 29 parcels to CRIC, an unrelated third party. On that same day, Great Lakes entered into lease agreements with CRIC to run the businesses on those 29 parcels and pay CRIC a defined rent. The leases are defined as operating leases in the agreements.

On November 10, 2004, the asset purchase agreement closed. CRIC acquired all of the parcels and Great Lakes acquired all of the leaseholds of the 18 leased properties so that it now operated all of the businesses and paid CRIC rent. CRIC filed real estate transfer returns on three of the properties and did not allege any “creative financing” was involved as the purchases were financed with cash and traditional mortgages.

In 2005, CRIC purchased three more leased parcels located in Milwaukee in the same manner. In 2005 and 2006 CRIC sold all of the parcels in the two prior transactions to various unrelated individuals. Again, CRIC filed the real estate transfer forms that identified the purchase prices financed as all cash, conventional financing or third party financing.

At trial, Great Lakes argued that “creative financing” in the form of a sale leaseback transactions inflated the sale prices. The trial court found the 2005 and 2006 sales were not sale leasebacks because at no time did the actual seller lease the properties back from the buyers; there was no special financing that impacted the sales and the leases were at market rates. The trial court stated that “[T]ransactions reflect the nature of today’s markets for the sale of single tenant investment properties.” The court affirms:

There is significant evidence to support the trial court’s findings . . .[that] a recent sale of the subject property be used to establish the value . . . The trial court properly rejected [Great Lakes’] formula because there were recent arms-length sales of the subject properties. The trial court’s findings that the leases did not reflect above market rents is supported by the evidence . . . Walgreen does not require a contrary result. [Citation omitted] . . . here there were arm’s-length sales that the court determined established fair market value . . . There were no sale leasebacks “because the seller of the real estate never leased the properties
back from the buyer. The lease rents did not included other “creative financing” costs which pushed the leases beyond market rates. . . .

The taxpayer also argued disparate treatment in valuation than other similar properties. The argument is rejected:

Here, there is no evidence that all other similarly zoned properties were systematically assessed at less than fair market value. [Citation omitted]. There is also no evidence that Great Lakes was arbitrarily singled out for reassessment based on factors equally applicable to properties not reassessed . . .

Simply comparing a taxpayer’s appraised value to lower values assigned to a relatively small number other properties has long been rejected as a claimed violation of the uniformity clause . . .

Bonstores Realty One LLC v. City of Wauwatosa, 351 Wis.2d 439, 450, 454-455, 839 N.W.2d 893 (Wis.App. 2013).

Issues: as-if-vacant;

The property is a department store anchor to a mall. The taxpayer asserted it should be valued as-if-vacant and used distressed or vacant sales in the sales comparison approach. The court rejected the use of these properties as not being comparable to an operating store with no foreseeable likelihood that it would discontinue operations.

. . . Bonstores effectively admits that at least some of the comparable properties were fairly characterized as “distressed.” Kelly confirmed that a store going “dark” may have a significant impact on the property. It appears from the record that the circuit court used the phrase “distressed property” to refer to a “dark” business. Kelly agreed that the subject property is not a “dark” store, has never gone dark, and there is no evidence it would go dark and be sold off as a single property. As such, the circuit court did not erroneously determine that Kelly’s reliance on the sales of properties he deemed comparable was unreliable.