Thinking Outside the Big Box

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Hardly a week goes by without news about a big-box store fighting its property tax assessment. Although big-box stores have existed for decades, challenges to the way they are assessed for property tax purposes have accelerated in the last few years. Recent court cases in the Midwest have some assessors reviewing their techniques for valuing these properties. This article examines the most common appeal arguments by big-box stores and relevant court cases and it recommends a method for estimating their market value.

Big-box stores were born in 1962 when several national retail chains experimented with a new prototype—a large store with a large variety of merchandise. Shopping became a family affair, where dad, mom, and the kids could wander through aisles and aisles of merchandise. One of the first retailers to try this new format was (the now defunct) Woolworths, which opened its first big-box store as Woolco. Other retailers such as Meijer, Walmart, Target, and K-Mart soon followed, and by the mid-1960s this type of store began to appear throughout the country. The term *big-box* stems from the store's most defining characteristic: its large size and windowless, box-like appearance. In those early days, *large* was 50,000 square feet, but today's big-box stores can exceed 200,000 square feet. They exist in almost every jurisdiction in the United States. A few examples are Walmart, Target, Meijer, Costco, Ikea, Home Depot, and Lowe's.

There is no accepted definition of big-box stores. They are often lumped into categories such as discount department stores (Walmart, Target, Meijer), specialty stores (Best Buy, Dick's Sporting Goods), and warehouse stores (Home Depot, Lowe's, Costco). Typically, these stores exceed 100,000 square feet and are located on 15- to 20-acre sites. While most big-box stores are single-story, they typically have a two- to three-story height. Although smaller stores such as Office Depot and Sports Authority could be considered big-box, this article focuses on stores larger than 100,000 square feet.

What makes a big-box store so challenging to assess? After all, it's just a big-box, right? No curves, angles, or unusual architecture to contend with. Arguably, the only unusual feature of big-box stores is their large size. For a property type that seems relatively simple, it is surprising how it generates an abundance of appeal arguments.

There are thousands of these stores throughout the United States, and more are being built every day. Big-box owners and their representatives rarely argue that the assessment of these stores exceeds replacement cost. Instead, the dispute typically centers on which comparables are most applicable. Because of the way these stores are bought and sold, the sales are either very high, sometimes exceeding development costs, or very low, considered bargain-basement prices by some.

Appeals

Big-box chains are organized and aggressive in their property tax appeals. About Walmart, a 2011 report by the nonprofit research organization Good Jobs First stated,

> *Using an army of lawyers and consultants, it systematically challenges property tax assessments to chip away at its property tax bills, costing local governments several million dollars a year in lost revenues and legal expenses* (Mattera 2011).

That comes as no surprise to those who must defend the assessments of Walmart and other big-box stores. Although all taxpayers are entitled to appeal assessments they deem unfair, the sheer number of big-box appeals suggests a larger strategy to lower property taxes across the board. Successful appeals in the Midwest have motivated big-box owners to expand their appeals far and wide.

Typical Big-Box Property Tax Appeal Arguments

The following are the most common arguments related to assessment of big-box stores:

- Big-box stores are becoming obsolete because consumers are shifting to online shopping and the large chains are shifting to a smaller store design.
- Sales of occupied big-box stores usually involve sale-leaseback transactions in which investors care more about the tenant than the real estate. These sales represent leased-fee value, not fee-simple value.
- Fee-simple value is best reflected by sales of vacant big-box stores because those properties are not encumbered by leases (aka the Dark Store Theory).

Walmart is the largest chain of what are traditionally referred to as big box stores

- The highest and best use of a successful operating store is no different than the highest and best use of a vacant abandoned store.
- Considering the business success of an operating store results in value in use, not value in exchange.

Big-Box Demise Due to Online Shopping

A frequent argument concerning big-box stores is that they suffer from obsolescence because of the threat from online retailers such as Amazon. The benefits of e-commerce are obvious: not only are prices sometimes lower, but also products can be ordered from home. The obsolescence argument suggests that consumers can easily purchase retail goods online, so there is no need to shop at the big-box stores. That argument is not new.

A 1989 *New York Times* article, "Rewriting the Rules of Retailing," stated,

> *Technology, in fact, is making it easier to stay out of stores entirely. Home television shopping, for instance, which peddles primarily low-priced items, is expected to move into higher-ticket goods. And shoppers can even buy products over their personal computers through such services as Prodigy, which is marketed by Sears and the International Business Machines Corporation.* (Wayne 1989)

This early prediction that online purchases would nudge out brick-and-mortar retailers was made a full five years before Amazon even existed. In the 25+ years since that article appeared, brick-and-mortar stores are still around, even flourishing. Pundits have been forecasting the demise of physical stores for decades. But retail giants such as Walmart, Lowe's, and Costco apparently didn't get the memo, because new big-box stores are being built every year.

What the experts overlook is that brick-and-mortar stores can also play in the online sandbox. All the big players have an online presence and, in fact, are incorporating online purchases into their overall strategy. As stated in Costco's 2014 annual report,

> *The lines between online and brick-and-mortar stores are blurring as multichannel retail is evolving as part of the everyday retail environment. Many of our members are well-traveled digital shoppers who research product features, check official reviews and conduct price comparisons online with the use of computers, tablets, and mobile devices. We see this as both a challenge and an opportunity, and continue to seek ways to enhance our website and mobile applications to better meet the needs of our members.* (Costco Wholesale Corporation 2014)

Costco's 2014 annual report stated that it continues to seek ways to enhance its website and mobile applications to meet its members' needs.

This new strategy, called *omni-channel retailing*, is being pursued by all the large retailers. There is no doubt that online shopping will continue to grow and affect sales from brick-and-mortar stores. But it's not an either/or scenario. Most consumers these days shop online and in-person at their local stores. In fact, the term *showrooming* was coined to describe the practice of consumers viewing merchandise in a traditional brick-and-mortar store, but then purchasing the same product online. Retailers have countered this practice by steering consumers to their own websites, price-matching, free-shipping, and allowing consumers to order online and then pick up merchandise in local stores. Some even have in-store kiosks from manufacturers such as Samsung, Apple, and Microsoft.

Despite the threat from online shopping, brick-and-mortar stores continue to dominate retail sales. A study of consumer practices by the International Council of Shopping Centers found that consumers spend significantly more per month in physical stores than online. It also found that 73 percent of consumers want to try on or touch merchandise before they purchase it (ICSC 2014).

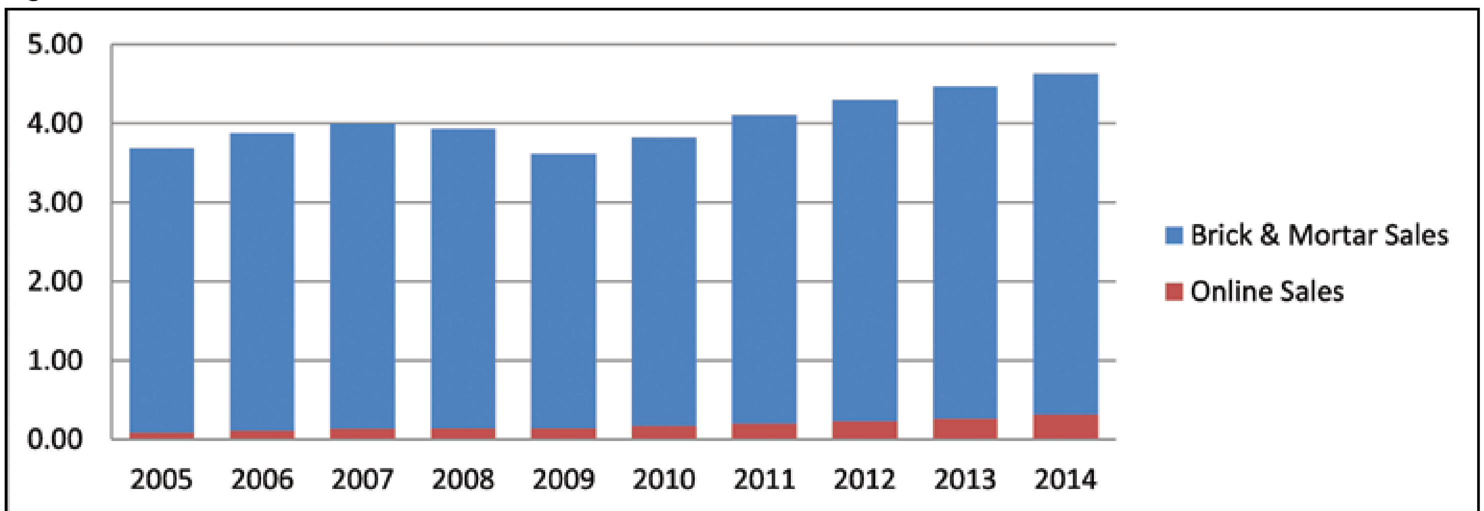
A comparison of brick-and-mortar sales with online sales reveals a surprising statistic. According to the Census Bureau, online sales represent only 7 percent of total retail sales nationwide; see figure 1 (U.S. Census Bureau 2015). Although that figure varies when the focus shifts to specific types of products, such as electronics, it still represents only a fragment of the sales generated in physical stores. In short, people still want to shop in stores.

Smaller Stores

Another common argument in big-box appeals is that large stores are obsolete, as evidenced by the national chains shifting to smaller stores. It is undeniable that the large chains are exploring different store concepts. Walmart actually has six different store types, ranging from its Supercenter, with approximately 180,000 square feet, to its Walmart Express, a 15,000-square-foot competitor to local drugstores. Despite the claim that the larger stores are being replaced by smaller ones, Walmart actually opened 130 Supercenters but only 121 small-format stores in 2014 (Walmart 2014). Interestingly, Walmart has converted or replaced many of its traditional 100,000-square-foot discount stores with the larger Supercenters.

According an article in *Market Realist*, in the past five years, Walmart converted or replaced 409 discount stores with Supercenters (Soni 2015). Walmart plans to open 120 new Supercenters in 2015 and another 60–70 in 2016. So although Walmart is forging ahead with the small-store format, it also continues to build large stores, in fact, very large stores. The Supercenter format provides several advantages. It allows Walmart to provide a wide variety of merchandise, and it also allows the large stores to serve as distribution points for the small-format stores.

Figure 1. Brick-and-mortar sales versus online sales ($ trillion) in the United States, 2005–2014 (U.S. Census Bureau 2015)



Walmart is not the only big-box retailer adding new stores. As table 1 illustrates, Target, Costco, Home Depot, and Lowe's are all opening new stores in 2015. Although some of these new stores will be small-format designs, most will be the traditional large-format design with more than 100,000 square feet.

Table 1. Largest big-box stores in the United States (The Home Depot Inc. 2014; Lowe's Companies, Inc. 2014; Target Corporation 2014b; Walmart 2014; Costco Wholesale Corporation 2014)

Company	Number of Stores	Stores Owned	Typical Size	New Stores for 2015
Walmart*	11,453	9,078	105,000	24
Home Dept	2,270	2,042	128,000	6
Lowes	1,840	1,541	109,000	15
Target	1,790	1,536	135,000	15
Costco	663	522	143,700	24

**includes 647 Sam's Club stores*

There is no doubt that consumer demand changes from year to year and decade to decade, and large retailers are constantly tweaking their store designs to cater to these demands. Retail will evolve in the coming years, just as it always has, but until retailers abandon the big-box design, it would be improper to adjust for obsolescence. Mark Twain once observed that, "reports of my death have been greatly exaggerated." If he were alive today, we suspect he might say something similar about big-box stores.

Sale-Leasebacks

Although the vast majority of big-box stores are owner-occupied, on rare occasions they do sell with a big-box retailer in place. This often happens when big-box owners sell their own property in a sale-leaseback transaction and remain as tenants. Sale-leaseback transactions usually involve *first-generation space*, a building often designed and occupied by the original tenant. These properties are attractive to investors because they are high-quality buildings, usually with desirable tenants. Sale-leaseback prices are based on the rent being paid, and the rent is typically based on the underlying development costs.

The argument against using these sales is that the sale prices represent the leased-fee interest (rather than fee-simple interest), and that investors care more about the creditworthy tenant than they do about the real estate. Some suggest sale-leasebacks are nothing more than financing arrangements, not market transactions that have been exposed to the open market. The big-box chains argue that because of these factors, sale-leaseback transactions should not be used at all.

The price paid by investors in sale-leaseback transactions is a leased-fee interest. Since fee-simple value is typically sought, an adjustment for property rights would be necessary if it is determined that a premium over and above the value of the real estate was paid. Although the rent being paid is typically based on the development costs, it is possible that investors will pay even more than cost to obtain the benefits of a credit-worthy tenant. This leased-fee premium would require a property rights adjustment to bring it in line with fee-simple value. In discussion of property rights adjustments in the sales comparison approach, the *Appraisal of Real Estate* states,

> *The appraiser must also consider any differences in the property rights appraised between the comparable properties and the subject property because the comparable sales may include the transfer of a leased fee interest* (Appraisal Institute 2013, 395).

So how do assessors measure the premium that investors might be paying so that a property rights adjustment can be made? One approach is to compare the value derived from the cost approach to the leased-fee sale price. The cost approach inherently excludes encumbrances such as leases and also intangible value that may result from above-market sale prices. If a sale price for a leased big-box store exceeds replacement cost, the difference could be attributed to the premium paid by investors and that could be the basis for a property rights adjustment.

So how do assessors measure the premium that investors might be paying so that a property rights adjustment can be made? One approach is to compare the value derived from the cost approach to the leased-fee sale price.

Unlike many other property types, big-box stores are not built to be sold. Instead, they are typically built and occupied by the owner. For this reason, the only first-generation big-box stores available for purchase are those that are being offered in sale-leaseback transactions or investor-to-investor purchases in which the big-box chains are tenants. These sales require research because of the issues previously mentioned, but like any other sale, verification will often reveal whether it is valid and whether adjustments for property rights are necessary. Sale-leaseback transactions represent an important piece of the puzzle in big-box valuation and should not be ignored.

Dark Store Theory

Owners and tax representatives of big-box stores suggest there is an easy alternative to sale-leaseback transactions—vacant big-box stores. The argument is that, since fee-simple represents unencumbered value, the best sales are vacant big-box stores because there is no lease involved. This approach has been coined the *Dark Store Theory*.

Big-box chains close underperforming stores every year. A 2014 Target press release spoke to store closings, saying,

> *The decision to close a Target store is only made after careful consideration of the long-term financial performance of a particular location* (Target Corporation 2014a).

Abandoned big-box stores are often occupied by furniture stores, churches, indoor flea markets, or similar second-tier uses.

When a big-box chain abandons a store, its actions indicate there may no longer be market support for that use at that location. Dark stores are typically closed because they were poorly located, had functional issues, or were part of a company bankruptcy or downsizing. Abandoned big-box stores are often occupied by furniture stores, churches, indoor flea markets, or similar second-tier uses. Dark store sales usually involve what is commonly called second-generation space. This describes a building whose original tenant has departed and has been replaced with a new user, and often there is a new use for the property. This situation is not exclusive to big-box stores. When unsuccessful grocery stores, drugstores, even corporate headquarters go dark, they are often sold at a fraction of their original cost and converted to a different use. Usually the use of the property changes because the property is no longer suitable for its original purpose.

Another factor that often affects dark stores is the restrictions placed on them when they are sold. Why doesn't Target purchase a closed Walmart store instead of building a new one in the same town? Because they can't. Walmart, Target, Home Depot, Lowe's, and other big-box chains use deed restrictions (sometimes called restrictive covenants) to prohibit rivals from operating in one of their former stores. Even if a chain made a poor decision by closing a store, it will never be known, because its competitors are blocked from purchasing or leasing the property through these deed restrictions and restrictive covenants. This is unfortunate for assessors, because those transactions would clearly demonstrate fee-simple market value.

Deed restrictions are akin to the removal of a stick from the comparable properties' bundle of rights; thus a transfer of such restricted properties would entail something less than fee-simple value. An example of these restrictive covenants is a deed restriction utilized by Target. In the deed transferring one of its properties, a clause states,

> *For a period of 10 years following the date of this conveyance, no portion of the subject property shall be used for the operation of a discount department store containing more than fifty thousand square feet of floor area. No portion of the subject property shall be used as a grocery store, containing more than 25,000 square feet of floor area for use in connection with the sale of food, groceries, fruit, produce, dairy products, vegetables, bakery products, meats, or delicatessen products.* (Bexar County Clerk 2007, 1918)

These restrictions typically last decades and can inhibit efforts to find buyers. Partially because of the deed restrictions, these stores can remain vacant for many months, even years. Dark stores often create blight in neighborhoods and can negatively affect a community because they attract vandalism and crime, discourage retail growth, and potentially affect adjoining property values.

Understandably, Target, Walmart, Lowe's, Home Depot, and other big-box chains have no interest in selling or leasing their closed stores to the competition. But for valuation purposes, these restrictions artificially alter the forces of supply and demand, preventing the *most likely market participants* from illustrating through their actions the true fee-simple market value of these properties.

If there is any doubt that big-box chains take these restrictions very seriously, consider the case of *Thirty 141 v. Lowe*

Dark stores often create blight in neighborhoods, attract vandalism and crime, discourage retail growth, and potentially affect adjoining property values.

Home Centers, Inc. (2010). In that case, a landlord leased a site to Lowe's and agreed to place deed restrictions on adjoining parcels to block rival home improvement stores. When the landlord failed to place restrictions on *all* adjoining lots, Lowe's successfully sued to force the landlord to do so.

The Appraisal Institute addresses the issue of deed restrictions as follows:

> *Some sale contracts call for the sale of real property rights but add deed restrictions or other forms of limitations on the purchaser or future users of the property. That sort of title or use limitation may limit the transaction's use to a general market indicator or render the transaction unusable for direct market comparison because the real property rights conveyed are less than fee simple.* (Appraisal Institute 2013, 406)

Highest and Best Use and the Selection of Comparables

Determining a big-box store's highest and best use as improved may seem obvious and even unnecessary, but highest and best use serves an important and critical purpose. The determination of highest and best use guides the assessor to the most appropriate comparables. According to the *Appraisal of Real Estate*,

> *Each improved property should have the same or a similar highest and best use as the improved subject property, both as though vacant and as improved.* (Appraisal Institute, 2013, 43)

Both sides in big-box appeals usually agree that the highest and best use of an operating store is continued use. Where they usually part ways is the selection of comparables. The assessor often chooses sale-leaseback transactions, while the taxpayer selects dark store sales. Sale-leaseback transactions usually occur at the beginning of a big-box store's life when the property is successful and thriving. Dark store sales occur at the end of a store's economic life, when a particular location is no longer popular and the property may be burdened with deed restrictions. Neither of these sales is inherently bad—it just depends on the property they are being compared with.

In appraising or assessing a dark store, the most appropriate comparables are sales of other second-generation stores, because they are similar in location, demographics, trade area, demand, and rent potential. In other words, they have similar highest and best uses. Instead, in assessing or appraising an operating first-generation store, the most comparable sales are other successful operating big-box stores, which are typically represented by sale-leaseback transactions. Using dark store sales (apples) to value first-generation, successful operating stores (oranges) or vice versa is a mismatch. These properties represent different highest and best uses. Because of the conditions surrounding dark store sales, they represent a different and inferior market or, in other words, their *second-best highest and best use.*

The valuation date for most assessment jurisdictions is January 1. Because most operating big-box stores do not actually sell on January 1, the assessor must assume a hypothetical sale between seller and *the most probable buyer*. The *Appraisal of Real Estate* notes the importance of identifying the most probable buyer, stating,

> *The most probable buyer is a critical conclusion used in choosing comparable sales in the sales comparison approach.* (Appraisal Institute 2013, 357)

So who is the most probable buyer for a big-box store in a hypothetical sale? Is it the big-box chains themselves since they build, own, and occupy most of the stores? There is ample evidence of what big-box stores pay to purchase land and construct buildings. Is it the investor that occasionally purchases stores in sale-leaseback transactions? A simple search in CoStar will find dozens of sales like that. Or is the typical buyer the second-generation user who purchases the store after the first-generation user (usually a national chain) abandons it? Dozens of vacant big-box stores are for sale around the country. In fact, Walmart has its own website, Walmartrealty.com, to dispose of these properties (with restrictions on future use).

The most overlooked market participant in big-box property tax appeals is actually the most obvious: the big-box chains themselves.

All three market participants—big-box chains, sale-leaseback investors, and second-generation users—have different motivations and thus different prices they are willing to pay. The perceived benefits from a creditworthy tenant may cause sale-leaseback investors to pay the most, even more than replacement cost. Second-generation store users would probably pay the least. They are typically buying a property that has failed for the first-generation user, and they must conform to deed restrictions that limit the use of the property. These purchasers often repurpose the property to something that is not blocked by deed restrictions, but that may not be the highest and best use.

The most overlooked market participant in big-box property tax appeals is actually the most obvious: the big-box chains themselves. They build, occupy, own, and sell more stores than any other market participant. They have intimate knowledge of the best designs, locations, and nuances that make one store more successful than another. They publish their store plans, projections, costs, achievements, and even

their store failures in annual investor reports that are easily accessible by appraisers, assessors, and the general public. Why is the most active and obvious market participant often ignored in the hypothetical sale of a big-box store?

Big-box chains are overlooked as potential buyers because of a common mistake in contemplating a hypothetical sale. That mistake is that many assume a hypothetical sale must be to *someone else.* For example, a common argument in drugstore property tax appeals is, Who would purchase a CVS store when a Walgreens is already on the opposite corner? The question fails to consider that CVS (or someone like them) would probably be first in line if the property were hypothetically offered for sale. The store's success as an operating drugstore would attract a drugstore user. They would probably not pay as much as the investor that seeks benefits beyond the sticks and bricks. But they would pay more than the second-generation user that cannot maximize the property. In fact, as demonstrated by the price they pay to purchase land and construct buildings, a typical drug store user would likely pay replacement cost.

In *CVS v. Turner* (2013), the court acknowledged this likelihood, saying,

> *It is logical that, should a drug store chain decide what to pay for one of these properties, the drug store would look to the costs involved in building a new store on a competing corner. As noted by Lee Lapierre, CVS itself 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 same logic is true for the big-box stores. There is no accepted appraisal theory that suggests an appraiser or assessor should exclude the present occupant, or a similar occupant, as a potential purchaser in a hypothetical big-box sale.

Value in Exchange versus Value in Use

The trap that assessors sometimes fall into when they point to the national chain occupant as a potential buyer is the issue of value in use. Despite the fact that most states require an estimate of *value in exchange*, in big-box appeals, assessors are sometimes accused of inappropriately applying *value in use*. The *Dictionary of Real Estate Appraisal* defines value in use as,

> *The value a specific property has to a specific person or specific firm as opposed to the value to persons or the market in general* (Appraisal Institute 2002, 306).

Critics argue that focusing on the occupant's business is improper and crosses the line into value in use. This criticism is not new. A court case early in the last century addressed this issue when the local assessor pointed to the success of a street railway company as support for his assessment. In *City Council of Marion v. Cedar Rapids* (1903), the court said,

> *The franchise of a street railway company is not assessable, but the fact that the railroad is in successful operation may be taken into consideration in fixing its value.*

It would seem reasonable, in fact necessary, to consider the success or failure of a business at a specific location in determining the value in exchange. We have all seen that certain stores or restaurants seem to fail over and over again, regardless of what business occupies it. That continued failure casts doubt on the viability of that use at that location. Alternatively, the continued success of a business tends to indicate that the property is operating at its highest and best use.

Use value and exchange value are different only when the current use is not the highest and best use. If an appraiser concludes that the current use (not the specific user) of a big-box store is also the highest and best use, then use value and market value are the same.

Where many assessors go wrong is that, instead of identifying a *typical* user for a big-box store, they point to a *specific* user, such as Walmart, Target, Home Depot, or Lowe's. True, these companies are the most common occupants, but it would be improper to conclude, for example, that the highest and best use is a *Home Depot*, rather than a *home improvement store*. This small nuance can result in a conclusion of value in exchange versus straying into the value in use territory.

It is true that value in use is based solely on a property's actual use, but that value is not always different from value in exchange. Use value and exchange value are different only when the current use is not the highest and best use. If an appraiser concludes that the current use (not the specific user) of a big-box store is also the highest and best use, then use value and market value are the same.

Similarly, assessors should be careful not to assess features that are so peculiar to a specific owner that others would not want them. Although Walmart, Target, Home Depot, and other big-box stores spend significant amounts of money for signage, no one other than Walmart could use a sign that says Walmart, so the fee-simple market value of that item is essentially zero, while its value in use is the depreciated replacement cost. Although the sign stanchion and electrical equipment could be used by anyone, the name itself has value only to Walmart.

Some argue that the design, colors, façade, and even layout of big-box stores are so unique to their specific users that they represent functional obsolescence to anyone else. To support that claim, they point to the costs incurred by subsequent owners to tailor a property to the new occupant's brand. But these tenant improvement costs are not unique to big-box stores. When almost any property sells, there will be changes and improvements that personalize a property for the new occupant. These changes are often cosmetic, such as painting, signage, and layout, but they do not rise to the level of functional obsolescence. In essence, the design of big-box stores makes them easy for other occupants to utilize. After all, it's a big box.

The Courts

The courts have sent mixed messages about the proper way to value big-box stores. Some recent cases from Michigan, Indiana, and Ohio indicate that assessors should embrace dark stores as comparables, while other decisions, sometimes from the same states, suggest the opposite. These seemingly conflicting opinions could be attributed to state law nuances, presented evidence (or lack thereof), confusion in the courts, or all of the above.

One case that has received a great deal of attention is the consolidated case of *Lowe's Home Centers, Inc., v. Township of Marquette* (2014) *and Home Depot USA, Inc. v. Township of Breitung* (2014). In that case, the Michigan Court of Appeals took issue with the assessor's appraiser concluding that the highest and best use was "continued use as a Lowe's home improvement center." In deciding in favor of the taxpayer, the court said,

> *Moreover, by taking the position that the HBU of the properties is use as a Lowe's and Home Depot store, respondents confuse the distinct concepts of fair market value (i.e., value-in-exchange) and value to the owner (i.e., value-in-use) by treating them as one in the same.*

The appraiser made the fateful decision to include the name of the business in highest and best use. Although many other issues were involved in the case, the misapplication of highest and best use was likely the lynchpin that persuaded the court to side with the taxpayer.

In *Hy-Vee, Inc. v. Dallas County Board of Review* (2014), the Iowa Court of Appeals sided with the assessor, whose appraiser indicated that the highest and best use was "continued use as a grocery store." In that case, the appraiser avoided concluding that a *specific user* would represent highest and best use, instead focusing on the most likely *use*. As these cases show, the distinction between use and user can make the difference between winning and losing.

What seems to garner most of the attention in big-box property tax appeals is the so-called Dark Store Theory. In almost every case we reviewed, dark store comparables were one of the primary issues. Again, the courts have been divided on whether these sales are appropriate to use in setting assessments. In *Home Depot v. Assessor of Town of Queensbury* (2015), the New York Supreme Court embraced the taxpayer's dark store sales and rejected the assessor's sales that were subject to long-term leases.

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Yet in *Daniel G. Kamin Cleveland Ents. v. Cuyahoga Cty. Bd. of Revision* (2015), the Ohio appellate court rejected dark store sales for a K-Mart, even though the store was in the process of closing and was actually vacant by the time the case made it to trial. The court upheld the assessment, saying,

> *[A]s of the relevant tax lien date, January 1, 2009, the property in question was leased and a fully-functioning retail store. It was not until late in 2009, well after the valuation date at issue, that the property owner learned that Kmart was going to close this store.*

In most of the big-box cases we reviewed, the issue of deed restrictions was seldom raised, despite the fact that dark store sales typically include restrictions that prevent them from being put to their highest and best use. In cases in which deed restrictions were highlighted, the court recognized their negative impact on the sale price and rejected their use in the sales comparison approach.

In *Target v. Kansas Court of Appeals* (2015), the court noted that many of the comparable sales used by the taxpayer were properties with deed restrictions preventing retail use, which were not comparable to an owner-occupied building (In the Matter of Equalization Appeal of Target Corp. 2015).

A Kansas court noted that many of the comparables used by Target in its appeal were properties with deed restrictions preventing retail use, which were not comparable to an owner-occupied building.

Similarly, in *Wal-Mart Real Estate Business Trust v. Town of Plymouth* (2010), the New Hampshire Board of Tax and Land Appeals recognized the negative impact of deed restrictions on highest and best use, saying,

> *All three Wal-Mart sales were for smaller, older stores where the Taxpayer had the atypical motivation of a seller having surplus property on its hands, once it decided to build a new store in the same market area and once it decided to encumber the sale of each old store with deed restrictions that limited the pool of potential buyers to exclude what it perceived to be its competitors. These factors tended to change the highest and best use of each property once the Taxpayer decided to sell it.*

The inclusion of dark stores as comparables usually results in the taxpayer's conclusion that the subject property suffers from functional and economic obsolescence. The price users are willing to pay for abandoned big-box stores pales in comparison to their replacement cost. That difference is typically attributed to obsolescence.

Such was the situation in the Ohio Supreme Court case of *Target Corporation v. Greene County Board of Revision* (2009). In that case, the taxpayer's appraiser successfully argued that,

> *[T]he fee simple market value of these properties is substantially lower than replacement costs, not only due to physical depreciation but also obsolescence. This obsolescence occurs the day they are completed; thus even brand new big box stores are worth less than their cost to rebuild.*

The logic that a successful, fully operational big-box store should be assessed the same as an abandoned, obsolete, deed-restricted, vacant building is lost on many assessors and even some courts. Ironically, the same Ohio Supreme Court ruled differently in *Meijer Stores Limited Partnership v. Franklin County Board of Revision* (2009). In that case, the assessment of a brand-new Meijer store was upheld, with the court saying,

> *Indeed, the owner by purchasing the land and constructing the building evidences a market need for such a property. Therefore, the costs of purchase and construction evidence that a prospective purchaser was willing to pay at least the costs of the property as newly constructed.*

The New Hampshire Board of Tax and Land Appeals came to a similar conclusion in *Wal-Mart Real Estate Business Trust v. Town of Rindge* (2011). Rejecting the taxpayer's estimate of functional obsolescence, the board said,

> *[T]here was no evidence presented that any functional obsolescence exists as the Property continues to operate for the purpose and the user for which it was constructed (its acknowledged highest and best use). It flies in the face of reason and business reality to conclude the Taxpayer and other similar 'big-box' users would continue to develop properties of this type with the knowledge that each store will have substantial functional obsolescence as soon as it is built and throughout its useful life.*

The inclusion of dark stores as comparables usually results in the taxpayer's conclusion that the subject property suffers from functional and economic obsolescence. The price users are willing to pay for abandoned big-box stores pales in comparison to their replacement cost.

Giving consideration to the business operating inside a big-box store resulted in conflicting opinions in two cases we reviewed. In *Lowe's Home Centers v. City of Grandville* (2014), the Michigan Court of Appeals said,

> *Even if the subject property is in fact continuously occupied and successful, these characteristics of the property are not relevant for determining the property's true cash value. They are accidents of ownership, not measures of value inherent in the property itself.*

The court thought that the assessor's consideration of Lowe's success was an attempt to incorporate value in use, contrary to Michigan law. But in *Soifer v. Floyd Cnty Bd. of Review* (2009), an Ohio court said,

> *To obscure the fact that this real estate is being operated as a viable McDonald's restaurant, a quite popular American establishment, would be to ignore reality.*

Interestingly, that case also involved deed restrictions, and the court opined on their effect on value, saying,

> *It would be contrary to legislative intent to allow a taxpayer to circumvent the statutory scheme by voluntarily eliminating buyers who would use the property in the same manner, thereby artificially reducing the potential sales price of the property.*

Although the Soifer case did not involve a big-box store, the issues are similar.

Legislation

Successful property tax appeals in many jurisdictions have had newsworthy reductions. In Marquette Township, Michigan, Lowe's successful property tax appeal resulted in a tax refund that ultimately caused the township to close the public library on Sundays (LaVecchia 2015). Major road repairs in Escanaba, Michigan, had to be shelved because of a property tax refund garnered by the appeal of a Menard's home improvement store (Dawsey 2015). A study commissioned by the Indiana County Assessors Association found that assessed values statewide could fall as much as $3.5 billion, or approximately $43 million in tax revenue, if the dark story theory was applied statewide (Dawsey 2015).

In Marquette Township, Michigan, Lowe's successful property tax appeal resulted in a tax refund that ultimately caused the township to close the public library on Sundays.

The impact of assessment appeals on big-box stores has caused some jurisdictions to turn to their state legislature to craft laws that would prevent reductions based on dark store sales.

In 2015, the Indiana General Assembly unanimously approved Senate Bill 436, which expands the definition of special-purpose properties to include retail buildings of 50,000 square feet or more. The bill directly targets the big-box appeals by requiring assessors to value them by the cost approach and prevents the use of dark store comparables. Language in the statute states,

> *If the effective age of the improvement is ten years or less, the sale of a comparable property may not be used in determining the assessment if the comparable property (1) has been vacant for more than one year [or five years, if the comparable property is an industrial property], (2) has significant restrictions on its use, (3) was sold and is no longer used for its original purpose, or (4) was not sold in an arm's length transaction. (Indiana 119th General Assembly 2015)*

In Michigan, a bipartisan group of state lawmakers comprising Senator Tom Casperson, Representative Ed McBroom, and Representative John Kivela, plans to introduce legislation in the fall of 2015 that would prevent the use of dark stores as comparables or those with deed restrictions that prevent retail use (Dawsey 2015). In a more unusual proposal, Michigan State Representative Scott Dianda introduced House Bill 4681 in June 2015, which would require big-box stores to pay a user fee if they successfully appeal their property taxes (Michigan Legislature 2015).

Recommended Approach to Assessment of Big-Box Stores

To correctly assess a big-box store (or any other property for that matter), an accurate determination of highest and best use must be made, appropriate approaches to value selected, and proper adjustments applied. These recommended steps are tailored for an estimate of fee-simple market value in exchange, the standard in most states.

Highest and Best Use

Identification of the correct highest and best use is critical, because it also serves as the basis for selecting the appropriate comparables. The assessor should review the current use of a big-box store and determine the most likely buyer in a hypothetical sale. If a store is occupied by a first-generation user and from all appearances the store is successful, the highest and best use is likely continued use as a first-generation big-box retail store (the assessor should be careful not to conclude a highest and best *user*, but instead, a highest and best *use*). Once it has been determined that the highest and best use is continued use as a big-box retail store, the selection of comparables begins.

Sales Comparison Approach

There are typically two types of sales of big-box stores, and both pose challenges for assessors. They sell either as occupied in a sale-leaseback (or subsequent investor-to-investor purchase) or as vacant after a big-box chain has abandoned a particular location.

The prices paid by investors in sale-leaseback transactions typically meet or exceed replacement cost, because the rent being charged is based on the original development costs—and the price paid is based on the rent. Critics of sale-leaseback transactions argue that the buyers in these transactions are more interested in the tenant, and they may pay a premium for the security that a creditworthy tenant provides. That argument is valid, and for that reason a property rights adjustment should be considered to ensure the adjusted price reflects fee-simple value. Adjustments for a property rights premium can be made in a number of ways. The easiest and most efficient way is to compare the sale price of a comparable to its replacement cost. Because the cost approach inherently reflects fee-simple value, a higher leased-fee sale price would suggest a property rights adjustment is warranted. Sale verification will confirm whether a sale-leaseback is a valid market transaction.

Sales of vacant big-box stores should also be considered. However, the assessor should ensure that the sale and the comparable have the same highest and best use. When big-box chains abandon a location, it is usually because the property failed. In addition, dark store sales are often burdened with restrictions that prevent them from being utilized for their intended purpose. A failed store usually results in a change of highest and best use, and the placement of deed restrictions almost guarantees it. Adjusting sales for these conditions is difficult if not impossible, and the use of sales with highest and best uses different from that of the subject property is improper.

Another option is to use fee-simple purchases of operating big-box stores by their users. National big-box chains occasionally purchase their own buildings through build-to-suit arrangements, and those sales are ideal because no lease is involved. But those sales are rare.

The two most common options in a sales comparison approach for big-box stores are sale-leasebacks and dark store sales, but both have challenges and limitations. Although it might seem tempting to discard the approach entirely, appeal boards and courts really like sales. However, they don't always like sale-leaseback transactions or dark store sales. Despite their limitations, the assessor would be well-served by analyzing and presenting both types of sales and, if enough data are available, performing appropriate adjustments.

Income Approach

The same limitations that affect the sales comparison approach affect the income approach. Big-box stores that are leased are either first-generation users in a sale-leaseback or former dark stores leased to secondary users.

For first-generation big-box stores that are leased, the annual rent is typically a function of the original development costs. Because market rent is required to estimate fee-simple value, it is important to determine whether the contract rent is above or below market, possibly influenced by the amount of time that has passed since the lease originated. Because contract rent is established in the year of construction and is typically fixed for the lease term, the rent may be outdated. Older stores typically have rental rates different from newer ones because construction costs change. For this reason, the assessor should carefully analyze contract rents to determine whether dated rental rates need to be adjusted for time.

An alternative to adjusting big-box contract rent is using rental rates from second-generation stores. Although second-generation big-box stores (former dark stores) are physically identical to first-generation stores, they have been rejected for retail use by the market. Whether the location did not meet expectations or the submarket was saturated with stores, these properties are no longer used for their intended purpose. In fact, rejection by market participants signals a change in highest and best use.

When big-box stores are closed, they are typically not offered for lease to competing users.

In addition, when big-box stores are closed, they are typically not offered for lease to competing users. Deed restrictions and lease clauses often prevent one national chain from leasing the vacated property of another. This constraint limits the ideal user from negotiating and establishing market rent. Although a competing chain might be willing to pay higher rent than a secondary user, the desire to block the competition from a closed store outweighs the need to maximize rent. Given these limitations, adjusting first-generation contract rent is the most accurate and effective way to determine a current market rent for an operating store.

When big-box stores are leased on a net-net-net basis, the property expenses are mostly borne by the tenant. Although landlords incur few costs, time may be required for oversight of the investment, and sometimes the landlord is responsible for major capital repairs, such as the roof and structural walls.

An assessor may want to account for these two factors by including a nominal expense estimate in the income approach.

Since lease terms for big-box stores typically exceed 20 years, vacancy is an insignificant factor, with the only risk the unlikely default of a tenant. However, in an estimate of fee-simple value, the assessor should utilize a vacancy rate typical for net-leased properties overall.

Capitalization rates from big-box sales reflect investor motivation to obtain both quality real estate and a dependable income stream from a highly rated national tenant. Although sales of other property types reflect similar motives, the security of national big-box chains is highly appealing. Investors are willing to pay more for these assets in exchange for the low risk and freedom from day-to-day management. But buyers do not want to pay more than they have to. Again, sale verification will indicate whether the price paid, and ultimately the capitalization rate, reflects market.

Some big-box appeals argue obsolescence due to the growth of online shopping, but this argument fails to hold water. True, online shopping is growing, but brick-and-mortar stores are still in great demand, as demonstrated by consumer sales and by the continued construction of new stores.

Like any other commercial property, one of the difficulties in applying the income approach to big-box stores is the availability of data. Obtaining contract rent on operating stores can be difficult, and sometimes dated leases require time adjustments. Rent from second-generation stores would not be appropriate to value operating first-generation stores because they represent a different highest and best use. Although the income approach does present challenges, if enough data are available, they can provide a good indication of value.

Cost Approach

The cost approach is the one technique for which data are almost always readily available. The cost approach can easily be applied to big-box stores, and there is little debate about the amount of construction costs required to bring big-box stores into existence. Similarly, land value is seldom an issue in big-box appeals. The biggest challenge in applying the cost approach is estimating depreciation. Physical depreciation can easily be estimated using a straight-line approach, but in the instance of functional and/or external obsolescence, the taxpayer and assessor typically disagree.

Functional obsolescence normally originates from defects in design. The *Dictionary of Real Estate Appraisal* defines functional obsolescence as,

> *An element of depreciation resulting from deficiencies or super adequacies in the structure (*Appraisal Institute, 2002, 122).

Big-box stores got their name because of their simplistic design and large amount of open floor space. Although big-box stores vary slightly because of user branding, they are largely similar, and it would seem that any design flaws have been corrected and not repeated. Because the national chains continue to build new stores of similar design, it would seem they have been almost perfected.

External obsolescence is defined as,

> *An element of depreciation; a defect, usually incurable, caused by negative influences outside a site and generally incurable on the part of the owner, landlord, or tenant ...* (Appraisal Institute, 2002, 106).

Big-box chains are very selective in choosing a location for their stores. It is not typical for a big-box store to be close to a negative influence, such as a landfill or an industrial use. Big-box stores are susceptible to the same negative economic forces as any property type, such as recessions and changes in consumer demand. Some big-box appeals argue obsolescence due to the growth of online shopping, but this argument fails to hold water. True, online shopping is growing, but brick-and-mortar stores are still in great demand, as demonstrated by consumer sales and by the continued construction of new stores.

The most typical argument for functional and external obsolescence by big-box owners and their representatives originates from the difference between the values derived from the cost approach and those from the sales comparison and income approaches. This obsolescence adjustment usually occurs when dark stores have been used as comparables for first-generation operating stores and the values they produce fall well short of replacement cost. Although this approach is valid, the selection of the wrong comparables will result in an incorrect estimate of obsolescence. In addition, this method should be used to calculate the impact of obsolescence that has already been identified. If the specific source of obsolescence cannot be identified, a conclusion of *phantom obsolescence* by comparing the approaches to value is questionable. Instead, the assessor should carefully review the property, the industry, the economy, and other factors to independently determine whether functional and/or external obsolescence exists.

Once the depreciated value of improvements is calculated and added to the land value estimate, the value by the cost approach can represent a reliable estimate of the market value of a big-box store.

After all three value approaches have been estimated, assessors weigh the applicability of each approach. For big-box stores, all three approaches to value have merit. Depending on the availability and quality of data and the amount of judgment required in making adjustments, one approach may be more beneficial than others.

Conclusion

For a property type that is fairly simple in design, big-box stores generate an abundance of appeal arguments and challenges for assessors. This article has discussed the typical appeal arguments, related court cases, and recommended approaches for assessing big-box stores. We hope that it has shed some light on these issues and provided assessors with a framework for assessing these properties. The key elements related to the assessment of these properties are as follows:

- The demise of brick-and-mortar stores as a result of online shopping is exaggerated. Online shopping only represents 7 percent of total retail sales. Although Amazon and other online retailers are having an impact on the retail industry, big-box stores continue to thrive.
- While national big-box chains are experimenting with smaller stores, they continue to build large, 100,000+ square foot stores. Until retailers abandon the big-box design, it would be improper to adjust for obsolescence based on speculation about future retail trends.
- Sale-leasebacks are leased-fee transactions that require verification and consideration of adjustments for property rights. They often represent the only sale of first-generation big-box stores.
- Sales of vacant big-box properties (dark stores) usually involve a failed store that has been abandoned by the first-generation user. A failed store usually results in a change of highest and best use. The use of a sale with a different highest and best use as a subject property is improper.
- Dark store sales are usually encumbered with deed restrictions that prevent occupancy by the most likely buyers. That use limitation may render the transaction unusable because the real property rights conveyed are less than fee simple.
- When evaluating highest and best use, the assessor should not exclude the present occupant (or someone similar) as a potential purchaser in a hypothetical big-box sale. Although the current occupant (or someone similar) can be considered a market participant, it would be improper to conclude that the highest and best use is a *Walmart* rather than a *big-box retail store*.
- The design of big-box stores is not so unique that it automatically results in functional obsolescence. Although big-box stores vary slightly because of user branding, they are mostly similar and can easily be altered for other users. Changes in design and branding after a sale are common and do not represent functional obsolescence.
- All three approaches to value are possible for big-box stores. The sales comparison and income approaches are the most challenging because of the way big-box stores sell and lease. The cost approach is often the most straightforward and supportable estimate of value.

Often the most reliable approach—and one that best reflects the behavior of the market—is the cost approach. As always, the assessor makes the final estimate of market value based on the best available data.

Big-box stores are not built to be sold. They are built for utility. When they sell occupied, it is usually a sale-leaseback, which represents a leased-fee interest. When they sell vacant, it is usually because a location failed and is deed-restricted and cannot be sold or leased to a competitor. These conditions present challenges in applying the sales comparison and income approaches to value. Often the most reliable approach—and one that best reflects the behavior of the market—is the cost approach. As always, the assessor makes the final estimate of market value based on the best available data.

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Fee Simple—In land ownership, complete interest in a property, subject only to governmental powers such as eminent domain.

Functional Obsolescence—Loss in value of a property resulting from changes in tastes, preferences, technical innovations, or market standards.

Highest and Best Use—A principle of appraisal and assessment requiring that each property be appraised as though it were being put to its most profitable use (highest possible present net worth), given probable legal, physical, and financial constraints. The principle entails first identifying the most appropriate market and, second, the most profitable use within that market. The concept is most commonly discussed in connection with underutilized land.

Leased Fee Estate—An ownership interest held by a lessor with the rights of use and occupancy conveyed by lease to another.

Net Lease—A lease in which the landlord (lessor) receives a stipulated rent amount and the tenant (lessee) pays all operating expenses and taxes attributable to the property. A net lease produces net income to the lessor.

Replacement Cost; Replacement Cost New (RCN)—The cost, including material, labor, and overhead, that would be incurred in constructing an improvement having the same utility to its owner as a subject improvement, without necessarily reproducing exactly any particular characteristics of the subject. The replacement cost concept implicitly eliminates all functional obsolescence from the value given; thus only physical depreciation and economic obsolescence need to be subtracted to obtain replacement cost new less depreciation (RCNLD).

Sale-Leaseback—A sale and subsequent lease given by the buyer back to the seller as part of the same transaction.

Value in Exchange—(1) The amount an informed purchaser would offer for property under given market conditions. (2) The concept that states value is based on the ability of property to command another asset, such as money, in trade.

Value in Use—The value of property for a specific use. The concept that holds value to be inherent in property itself, that is, the value is based on the ability of the asset to produce revenue through ownership.

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