What is “Dark Store Theory?”

- When big box retailers argue that their stores are built to serve the needs of their specific big box and have limited functional utility to other retailers.

- When retailers like Menard’s and Lowe’s argue vacant, abandoned stores are worth the same as a functioning store.

- When retailers say that their taxes should be calculated as if their stores were vacant or “dark,” rather than when they are at full capacity.

- When lawyers representing retailers say that big-box stores are effectively worthless at the point of sale, which should be reflected in the taxes they pay—even while the stores are still active.
Across the country, corporate giants such as Target, Lowe’s, and Home Depot—are pushing back on how local governments assess the value of their properties with the goal of lowering their tax bills.

Appraisal districts want to value the property at its current highest and best use, while property owners want the valuation based on sales of vacant properties — the highest and best use for the next occupant, which may have an entirely different sort of business.

So far, the strategy has worked, and has led to lowering the taxes of big-box companies by hundreds of millions of dollars across the nation.

According to an August 2017 report by Education Week, the trend is most pronounced in the upper Midwest, where hundreds of lawsuits and appeals have been launched in Michigan, Indiana, and Wisconsin.

In Michigan specifically, the argument has been made in roughly two-thirds of the state’s counties, resulting in a loss of more than $100 million in property taxes since 2013.
The Costs

THE COSTS OF ‘DARK STORE’ TAX LOOPHOLES

Big-box retailers in some states have fought aggressively to lower property taxes on their stores, a move local officials say exacts a deep toll on public services, including schools.

MICHIGAN

- Roughly two-thirds of the state’s counties lost at least $75 million in property taxes between 2013 and 2015.

WISCONSIN

- More than 210 cases have been filed by big-box property owners over the last decade or so in 26 counties that make up 36% of the state.

INDIANA

- Retailers’ successful use of the dark store argument affected more than 17,000 parcels of land in the state.
- And resulted in estimated property tax savings of $120 million in one year for corporate powerhouses.

TEXAS

- The state’s comptroller estimates dark store loopholes could cost local governments $2.6 billion annually within five years, including nearly $1.2 billion in lost property taxes for schools.

SOURCES: Michigan Association of Counties, the Association of Indiana Counties, Indiana County Assessors Association, Wisconsin League of Municipalities, Austin American-Statesman.

EDUCATION WEEK
Red Flag for Market Investors

- Dark store theory presents an emerging risk type issue that could have a substantial credit impact.

- In addition to losing future property tax revenue, stores are also getting refunds on their previous payments.

Per S&P Global Ratings - One Indiana case involving the Town of Merrillville resulted in a $2.3 million award to Meijer supercenters for taxes paid in prior years plus interest.

At the time of this same S&P Global Ratings report, Merrillville was also facing 21 additional property tax appeals from big box retailers “which could have significant and lasting effect on its fiscal health and ability to continue funding services at current levels”.

An Emerging Risk

- Dark store theory is little known or understood in the broader municipal credit sector.

  (Not yet aware of a negative rating action tied to a specific appeal.)

- Given the size of some of the settlements, as well as the sheer number of big-box stores scattered throughout the U.S., the potential exists for the growing use of dark store theory to contribute to widespread fiscal pressure for certain types of issuers.

- Dark store arguments are being made by pharmacies, auto parts stores, and fast food chains. Experts believe there’s some potential for these arguments to be employed even more widely than they have been.

The basic argument regarding functional obsolescence seems to apply equally well to other types of properties, giving rise to the potential for a ‘domino effect’ of property tax appeals.
Outside the Midwest?

- Whether it’s Michigan, Wisconsin or Tennessee or Florida, Property Tax continues to be the most significant tax that all businesses pay annually whether it’s on their real property holdings or on personal property used as part of the business operations.

- While the trend is most pronounced in the upper Midwest, dark store tax appeals have been seen in many southern states as well, including Florida, Texas, Alabama, Mississippi and purportedly Tennessee.
  
  Alabama counties continue to fight numerous lawsuits.

  In Mississippi, the judge dismissed an appeal by Walmart, Home Depot and Lowes. However, advocates may seek relief through the legislative process.

- In 2013, Dark Store Theory suffered a substantial defeat in Florida, in part, due to favorable Florida statutory language that specifically requires an appraiser to consider the present use of a property as part of its highest and best use analysis.

  The case, however, also hinged in part on the absence of a restrictive covenant. (State laws generally allow for enforcement of restrictive covenants and do not provide an exception for property tax valuation purposes.)
Motivation

- Real estate taxes are typically one of the largest expense items on the income statements and balance sheets of most brick and mortar retailers.

- In today's growing e-commerce marketplace, retailers are being forced to close their less profitable stores.

- As one of the largest expenses, a store's tax burden weighs heavily among the factors a retailer will consider in deciding which stores to close.

What you do today can improve all your tomorrows!!
Self-imposed Functional Obsolescence

- Big box retailers have also argued that their stores are built to serve the needs of their specific big box and have limited functional utility to other retailers.

- However, their use of anti-competitive (deed) restrictions suggests otherwise.
Deed Restrictions

- One of the principal reasons big box retail stores remain vacant after closing is that retailers often use anti-competitive restrictions to prohibit the sale of the property to other big box retailers or other similar retail users.
- When a retailer quits a store, it's often just moving down the road or across town and doesn't want a competitor to move into its empty space.
- They use deed restrictions to prohibit the future sale of food, clothing, garden equipment or whatever might be considered competitive.
- These restrictions make the real estate hard to sell, as it's simply not comparable to a property with no restrictions.
In 2016 the Michigan Court of Appeals concluded that while deed restrictions distorted the market for big box stores, the resulting low sale prices alone did not reflect functional obsolescence.

That is, to argue a hinderance in a property’s ability to function in the market, one must identify or explain the deficiencies impeding functionality - a fact that is likely to have important implications going forward.
In the past several years, legislators in Michigan, Wisconsin and many other states have attempted to pass legislation intended to prevent big box retailers from considering vacant or “dark” stores when valuing properties.

Indiana, the only state that has enacted legislation to combat dark store theory, has continued to see challenges by commercial property tax payers using the same type of argument.

Although thus far largely unsuccessful, these legislative attempts continue to gain momentum and new legislation is in the works across many states that would close this "loophole."
Tax Increment Financing

- Urban Renewal Authorities, Community Redevelopment Areas and Downtown Development Authorities rely on Tax Increment Financing to encourage and fund new investment in blighted areas that otherwise might not attract development.

- In many cases, bonds have been used to pay for public improvements required to attract new development with the expectation that these improvements would add economic value.
Unintended Consequence

- If a new development comes in and successfully appeals its assessment, the ability of these governmental entities to raise revenues and pay off the bonds can be completely undermined, thereby challenging the overall sustainability of a brownfield redevelopment initiative.

- Smaller URAs, CRAs and DDAs, with less diverse tax bases, may face a significant structural budget gap from successful dark store appeals.
While many states are drafting legislation that would eliminate the dark store “loophole” and determine once and for all what comparables should be used to value an operating commercial property, you need to be prepared.

In some instances local governments handled their cases poorly, did not adequately prepare, and consequently allowed damaging legal precedent to be set.

In others, communities came prepared and successfully defended their property tax assessments.

Local governments with a well prepared case, their own experts, and well-articulated arguments to justify their appraisals can separate themselves from damaging legal precedent and those that simply rely on their appraisals as *prima facia* showing of proper value.
One Thing is Certain

- When big-box retailers shutter their brick and mortar locations—everyone loses, especially the local communities that depend on these stores not only for their property tax revenues, but for the jobs they provide and the goods they sell.
Questions?

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