S&P Global
Ratings

RatingsDirect®

Dark Store Tactic By Big-Box Retailers Could Pressure U.S. Municipal Budgets And Credit Quality

Primary Credit Analyst:
Scott Nees, Chicago (1) 312-233-7064; scott.nees@spglobal.com

Secondary Contact:
Geoffrey E Buswick, Boston (1) 617-530-8311; geoffrey.buswick@spglobal.com

Table Of Contents

Going Dark: The Debate Over Big-Box Valuation

Dark Store Appeals Likely To Spread Further

Online Commerce Versus Brick-and-Mortar

Fiscal And Credit Implications For Local Governments

Dark Store Tactic By Big-Box Retailers Could Pressure U.S. Municipal Budgets And Credit Quality

Household name big-box retailers and home improvement stores such as Lowe's, Home Depot, Sam's Club, Wal-Mart, Target, and Kohl's have begun using a controversial new legal tactic to appeal their assessed valuations and reduce their property tax bills in several states across the U.S. Using what has come to be called "dark store theory," big-box stores have argued that their in-use stores should be valued equivalently to vacant (or "dark") stores for taxing purposes. In states such as Michigan and Indiana, this argument has largely withstood judicial scrutiny, leading to hundreds of store devaluations and to hundreds of millions of dollars in estimated lost tax revenue to local governments. While S&P Global Ratings has yet to see a negative rating action tied to a specific dark store appeal, it recognizes the potential for these types of appeals to pressure local government budgets, cause unplanned draws on reserves and liquidity, and lead to generally weaker credit quality for some issuers.

Overview

- Arguing that their in-use stores are functionally obsolescent, big-box stores have systematically pressed tax appeals in a few states, causing widespread store devaluations and pressuring local government budgets.
- S&P Global Ratings expects dark store theory to spread throughout the country, particularly as competitive pressure from online retail mounts.
- The issuers likely to see the greatest effects will include those with tax bases more heavily concentrated in retail and those with weaker reserves and a limited ability to raise revenues to offset the losses from a successful dark store tax appeal.

Going Dark: The Debate Over Big-Box Valuation

At the heart of the dark store controversy is a debate on how best to assess the value of big-box stores for taxing purposes. The traditional, "cost" approach gauges the value of a store by adding the purchase price of the land on which a store is built to the cost of constructing the big-box building itself, less depreciation. A building that is newly constructed at a cost of $10 million will, on this approach, be assessed at $10 million in the first year and depreciated by some fraction of the initial cost in each subsequent year.

Dark store theory contends that the cost approach fails to adequately appreciate the role of functional obsolescence in reducing the value of big-box stores. A big-box store is constructed with highly specialized features (such as size, layout, façade, and signage) that suit the very specific needs of the building's original user. Consequently, they cannot be readily adapted for reuse by a second-generation user without significant investment, a characteristic that lowers the resale value of these properties on the secondary market. This kind of functional obsolescence is not accounted for when valuing the store based on construction costs, less depreciation.

Because of the purported shortcomings in the cost approach, dark store theory proponents favor a "sales comparison" approach, where a store's value is determined by examining the selling price of comparable properties, much as home values are determined by looking to recent, comparable home sales in an area. The vast majority of big-box sales are of vacant (dark) stores, which often sit unoccupied for years following the departure of the original tenants and are sold to second-generation users at a steep discount. Not surprisingly, the use of dark store sales comparables typically yields a substantially lower assessment than that arrived at using the cost method.

Dark Store Appeals Likely To Spread Further

Dark store theory emerged most conspicuously out of Michigan and Indiana in the aftermath of the Great Recession, though we have observed dark store tax appeals in many other states as well, including Florida and Texas. In 2010, the Michigan Tax Tribunal (MTT) sided with Target Corp. when it used dark store arguments to appeal the valuation of one of its stores in a Detroit suburb. The MTT's decision in this and a string of subsequent cases set precedents that paved the way for big-box devaluations throughout the state. Several years on, in a statistic that gives some sense of the cumulative effects of years of widespread dark store appeals, the Michigan Municipal League reported that the typical Michigan Lowe's store is now assessed at $22.10 per square foot, compared with $79.08 per square foot in North Carolina, where the store is headquartered.

In neighboring Indiana, a very similar story has unfolded over the same period, culminating most recently in a closely watched case in which the state Supreme Court delivered a major victory to big-box stores. In 2017, the Court chose to deny review to an appeal of a lower court's decision in favor of Kohl's in a dark store tax appeal in Howard County. In that case, the Indiana Tax Court had accepted Kohl's argument that the Howard County assessor had overvalued the store by approximately $2 million. The Tax Court's decision resulted in a roughly 40% reduction in the store's value and required the county to repay taxes it had previously collected over a three-year period based on the higher assessment. More importantly, the refusal to hear the case in effect validated the use of dark store theory under current law, clearing the way for appeals to continue to proceed throughout the state.

While dark store theory has succeeded for big-box retailers in a few Midwestern states, it has either yet to spread to other states or has been much more limited in effect outside of the Midwest. We think there are good reasons to expect this to change, however, as these early successes on the part of retailers in places like Michigan and Indiana are likely to signal the potential legal viability of dark store arguments and suggest that these successes are replicable in other states. There are also compelling incentives at play that, in our view, will likely encourage dark store theory's proliferation. Many of the successful appeals that we have observed have resulted in tax settlements in the millions of dollars, and at comparatively little cost to the big-box retailers. Furthermore, a few favorable court decisions upholding the validity of dark store theory can reverberate throughout a state, as in both Michigan and Indiana, resulting in scores of in- and out-of-court settlements and compounding the potential gains to retailers many times over.

We have also observed the use of dark store arguments by pharmacies, auto parts stores, and, in a few instances, fast food chains, and believe there's some potential for these arguments to be employed 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 across the commercial and industrial portions of the tax base, which, were it to occur, could have a much more profound effect on some governments' ability to levy ad valorem property taxes on a significant cross-section of taxpayers.

Online Commerce Versus Brick-and-Mortar

Perhaps not coincidentally, dark store theory is emerging at precisely the same time that traditional brick-and-mortar retailers are facing mounting competitive pressure from online retailers, including e-commerce giants such as Amazon. Data from the U.S. Department of Commerce show that whereas a decade ago, online sales represented only a very small fraction of total retail sales, the online share has been steadily increasing and was more than 9% in 2017. This trend is, no doubt, alarming to many traditional retail stores, whose cost structure also happens to include often-sizable property tax bills from hundreds of store locations throughout the U.S., a cost not borne to the same extent by their e-commerce rivals. We think that as competition from online retail continues to grow, brick-and-mortar retailers will likely look to new and more creative ways of cutting costs, including appealing property assessments.

For more on recent developments in retail and their effects on governments, see "Sea Change In The U.S. Retail Sector Could Shake Up The Long-Term Stability of Sales Tax Revenue Bonds" (published on RatingsDirect on Aug. 7, 2017) and "U.S. States May Have Solved The Riddle of Lost Online Sales Tax" (published on April 24, 2017).

Fiscal And Credit Implications For Local Governments

To fully appreciate the potential significance of dark store appeals to a local government, it's critical to note that individual store appeals can result in multi-million dollar settlements, and a single government can be subject to multiple dark store appeals simultaneously. The town of Merrillville, Ind., for instance, recently lost an appeal to Meijer and has to pay settlement costs of $2.3 million for taxes collected in prior years, plus interest. We understand that the town is facing 21 separate appeals from big-box retailers, which could have a significant and lasting effect on its fiscal health and ability to continue funding services at current levels.

Typically, larger cities and counties aren't as dependent on taxes from one or a few big-box stores to fund core parts of their budgets. Smaller issuers, however, with less diverse tax bases may face a significant structural budget gap from successful dark store appeals and are potentially more vulnerable, as are those issuers who lack the ability or willingness to replace lost revenues following a successful appeal. Some governments, for instance, face statutory limits on their ability to raise additional taxes, including tax rate caps and circuit breakers, which could limit their ability to replace lost revenues. And even in the absence of any explicit statutory hurdle to raising taxes, many governments will still face practical and political limits on raising taxes on other classes of taxpayers, including homeowners and small businesses as opposed to seemingly anonymous and well-heeled national chains.

Other vulnerable issuers include those with relatively weak reserves and liquidity and those who lack the financial management policies and fiscal flexibility to enable them to maintain a healthy financial position through a large tax appeal and to make timely budget adjustments following one. In short, issuers with weaker reserves and weaker fiscal planning and expenditure flexibility won't be well positioned to handle, for instance, a $2 million tax settlement without significantly compromising their financial position in a way that could threaten credit quality.

As an emerging risk that has yet to be experienced widely outside of the Midwest, we think that dark store theory is little known or understood in the broader municipal credit sector. As noted, we haven't seen a negative rating action tied to a specific appeal, but 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.