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Invalid "dark box" property tax claims misinform Indiana and Michigan Legislatures

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Some have recently called this the dark box theory. However, what some are now calling the dark box theory is simply traditional accepted valuation methodology. Indeed, among appraisal professionals, it is the use of comparable sales of occupied stores that generates controversy and is often inappropriate to value an owner-occupied store.

If the criticisms of valid appraisal methodology are not legitimate, why has this issue received so much attention? One cause is the financial pressure on localities due to lower property values from the Great Recession. Not only did property values fall after 2008, but many businesses closed altogether. Communities have faced not only a loss in jobs but also decreasing property values. In both Michigan and Indiana, that pressure was compounded by the application of property tax caps. Public coffers to support local services have been squeezed, and state governments have not provided additional funding.

Another root cause was self-inflicted: the unjustified, over-assessment of new big box stores. Assessors used construction costs and land cost as the "market value" of the property, despite the fact that, like a new car or a newly tailored suit, the market value of these properties is always less than the cost of construction.

The purported problem is also one of public perception. If a retail store is operating, with inventory on the shelves and customers in the aisles, it may be difficult for the general public and local officials to understand why it is appropriate to value the property by using a transaction of a similar store that was vacant at the time of sale.

Trained assessors, however, should know better. They are legally required to only value the property itself, i.e., its "sticks and bricks" as well as the land. The occupants and content of the property have no relevance to the market value of an owner-occupied real property. Most states separately tax the business activity conducted on a property through income and sales taxes. Assigning value to property based on a taxpayer's business operations will unlawfully tax properties based on both intangible assets and intangible factors, and result in non-uniform taxation of similar properties.

Indiana Board of Tax Review Decisions

In December of 2014, the Indiana Board of Tax Review (IBTR) issued two opinions, which in most respects were no different than hundreds of rulings that preceded them. In both cases, taxpayers prevailed after the IBTR concluded their USPAP-compliant appraisals represented the best evidence of value. In the first case, involving a freestanding 237,000 square foot big box store in Indianapolis, the taxpayer's appraiser developed and relied upon the sales comparison and income approaches to value (assigning more weight to the sales approach) to reach value conclusions for multiple tax years. In the second case, involving an 88,000 square foot big box store attached to a shopping center, the taxpayer's appraiser developed all three approaches to value but relied on and assigned equal weight to the sales comparison and income approaches to value.

In both cases, the taxpayers' appraisers used sales of vacant stores. Each appraiser adjusted those sales to reflect the differences between the appraised store and the comparable stores. Neither appraiser relied exclusively on the sales comparison approach to value. Consequently, the IBTR's rulings in both appeals were not based solely on the supposed "dark box" sales, and the sales that were relied upon were adjusted to reflect differences between the subject and the comparable properties, with respect to physical condition, location and other factors.

That nuance was lost on the assessing

community as a whole and the subsequent statewide media reporting. The public was told that the IBTR incorrectly compared an active store with a defunct one. Yet, a sale of a vacant store represents the transfer of the real property alone, without the value of the business operations, which is exactly what should be valued under the law. The flawed and overly simple criticisms of the IBTR's decisions were repeated often, and loudly. Unfortunately, the Indiana General Assembly listened.

The Indiana Legislative Reaction and its Subsequent Fallout

2015 Legislation

After much heated discussion, the Indiana legislature, in the waning hours of its 2015 session, passed two provisions addressing "dark box" assessments in Senate Bill 436. The first provision (Section 43) was directed at big box stores. Assessors were directed to assess newer stores (those with an effective age of ten years or less) using a modified cost approach, accounting for physical depreciation and obsolescence.

The second provision (Section 44) impacted all "commercial non-income producing real property, including a sale-leaseback property." In determining the true tax value of qualifying properties with improvements with an effective age of ten years or less, a "comparable real property sale" could not be used if the comparable, among other restrictions, had been vacant for more than one year as of the assessment date.

Sections 43 and 44 were not well received. The IBTR issued a memo noting the new law contained "provisions that run counter to generally accepted appraisal practices."

2016 Legislation

Indiana's 2016 legislation session saw a complete repeal of Sections 43 and 44, effective January 1, 2016. House Bill 1290, Section 13, added Ind. Code § 6-1.1-31-6(d) to provide: "With respect to the assessment of an improved property, a valuation does not reflect the true tax value of the improved property if the purportedly comparable sale properties supporting the valuation have a different market or submarket than the current use of the improved property, based on a market segmentation analysis." Any such analysis "must be conducted in conformity with generally accepted appraisal principles." And the analysis "is not limited to the categories of markets and submarkets enumerated in the rules or guidance materials adopted" by Indiana's property tax rulemaking agency, the Department of Local Government Finance (DLGF), which is the agency that was directed to develop rules classifying improvements in part based on market segmentation.

What does this mean? That remains to be seen. Subsection 6(d) will undoubtedly be litigated before the IBTR and Indiana Tax Court, and the DLGF is in the process of developing its market segmentation rules. We do know two things: (i) the party challenging use of comparable sales must provide the market segmentation analysis; and (ii) the analysis must be based on generally accepted appraisal principles. No presumption exists under the statute that a sale is excluded. Exclusion must be proven with expert analysis.

Subsection 6(d) will lead to more costly appeals, with additional expert testimony and reports on market segmentation being required. As appeal expenses increase, litigants are likely to adopt tougher settlement positions, which will cause fewer cases to settle. As litigation takes longer to resolve, local officials' uncertainty regarding the tax base will also increase.

Section 13 also added Ind. Code § 6-1.1-31-6(e), which cemented a long-standing principle of Indiana assessment law, i.e., that true tax value "does not mean the value of the property to the user." To illustrate, the assessed value of a big box store owned and operated by Wal-Mart cannot be based on the specific value that the store has to Wal-Mart due to, for example, how Wal-Mart uses its unique marketing and employee training standards to sell its distinctive product mix.

Proposed Michigan Legislation – HB 5578

As in Indiana, Michigan government representatives have been waging a public relations campaign that has misled the public, including policy makers. The legislation drafts originally circulated were influenced by Indiana's legislation. Ultimately, on June 8, 2016, the Michigan House passed House Bill 5578 ("HB 5578"). Among its many significant flaws, HB 5578 prevents use of the sales comparison approach in cases where its use would be appropriate, and forces reliance on the cost approach, without accounting for all forms of obsolescence. It is not yet known what will happen to the bill in the Michigan Senate.

HB 5578's Required Findings of Fact

HB 5578 requires many specific findings of fact by the Michigan Tax Tribunal in a tax assessment appeal. Among others, HB 5578 requires specific findings of fact regarding: the market in which the subject property competes, the highest and best use of the property under appeal, the reproduction or replacement cost, and comparable properties in the market that have the same highest and best use.

While the listed factors are appropriate to consider in a valuation appeal, requiring specific findings of fact will be extremely burdensome and, in some cases, is ambiguous or unworkable. For example, an automotive assembly plant in Michigan might compete with automotive plants in the Midwest, Canada and Mexico and the automobiles produced at the plant could be shipped worldwide. HB 5578 provides no ascertainable standards on how one determines "the market in which the property subject to assessment competes."

HB 5578 requires calculation of a "replacement or reproduction cost for property that has the same . . . age as the property subject to assessment." It is nonsensical to calculate the construction cost to reproduce or replace property that has the same "age" as the property under consideration because, as an example, one cannot construct a 40-year old building. Presumably, what was intended was that cost new would be calculated, with a deduction for the depreciation of the subject property due to age. However, that is not what the plain language of HB 5578 requires.

HB 5578's Exclusion of Comparable Properties

HB 5578 requires that a comparable property be excluded if its "use" is different than the highest and best use of the property subject to assessment. It is unclear what the term "use" means as applied in this subsection and whether it means "actual use when sold," "subsequent use after sale," or "highest and best use when sold."

The proposed legislation also allows a comparable property to be considered "if the sale or rental of the property occurred under economic conditions that were not substantially different from the highest and best use of the property subject to assessment unless there is substantial evidence that the economic conditions are common at the location of the property subject to assessment." This provision is absurd. It is impossible to compare "economic conditions" with "highest and best use" and, even if it were possible, it would not make any sense to do so.

For the sale of a comparable property that was vacant at the time of sale, HB 5578 requires consideration of whether "the cause of the vacancy is typical for marketing properties of the same class." How is a "cause of vacancy" ever "typical for marketing"? HB 5578 further requires consideration of whether "the vacancy does not reflect a use different from the highest and best use of the property. . . ." Conspicuously missing from HB 5578 are any instructions as to the determination of how a vacancy reflects a use.

HB 5578 requires exclusion of a comparable sale property if the comparable property was subject to a deed restriction or covenant, "if that restriction or covenant does not assist in the economic development of the property, does not provide a continuing benefit of the property, or materially increases the likelihood of vacancy. . . ." What is missing from this analysis is any consideration as to whether such a deed or covenant would impact the price at which the property sold. For example, a reciprocal easement on the comparable property that did not "assist in the economic development of the property" but did not impact its sale price likely would be enough to exclude the comparable sale. Such reciprocal easements are commonplace and generally do not affect the price at which property sells.

Conclusion

Few would challenge the fundamental principles that property tax assessments should be uniform and should reflect the value of the fee simple interests of the properties – not the values of the business operations conducted thereon. Yet, the "dark box" bogeyman threatens these cornerstone valuation principles. In both Indiana and Michigan, new legislation gives taxpayers good reason to fear that in future years they may be faced with inflated property tax bills based on non-uniform and inequitable assessments. ■

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