

Supreme Court Decision Rejects Use of Creative Financing Arrangements to Inflate Property Tax Liability

Assessors in Wisconsin will no longer be able to increase property tax assessments based on above-market rents that are often the result of creative financing arrangements based upon a result of a recent Wisconsin Supreme Court decision. In *Walgreen Co. v. City of Madison*, the Supreme Court invalidated a method of assessing that had been used in 30 of the largest Wisconsin cities. Walgreen Co. was represented by Don Millis, a shareholder in Reinhart's Madison office and a member of the Reinhart Property Tax Team.

Creative Financing Often Leads to Above-Market Rents

In certain creative financing arrangements, such as sale leasebacks, the rent that is ultimately charged has little relationship to the market value of the property being leased. Often the level of the rent reflects the creditworthiness of the tenant or the total value of a business, including business value, real estate and personal property. As such, rents charged in such leases often far exceed market rents.

Similarly, the way in which Walgreen develops its stores also leads to above-market rent. (Walgreen leases the majority of its stores from unrelated third parties.) All of the costs associated with the development of Walgreen stores—land acquisition (often at a premium), tenant relocation, razing of improvements, environmental remediation, construction, and developer's profit—are all rolled into a rent payment that is typically well above market rent. Of course, when a Walgreen store with an above-market lease sells, its value is driven by the lease terms and the creditworthiness of Walgreen the tenant. These sales prices bear little relationship to the actual real property that is being conveyed.

Starting in 2001 and 2002, assessors in a few communities began to assess Walgreen stores based solely on these above-market leases. By 2008, about 30 communities based their assessments on above-market leases or sales of Walgreen stores with these above-market leases. The Supreme Court's decision

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will put a stop to these assessment practices.

Court Rejects Use of Above-Market Rents in Assessing Property

In reversing decisions of the Dane County Circuit Court and the Court of Appeals, the Supreme Court distinguished the leased fee value of property (*i.e.*, the value based on the lease) from the fee simple value of the property (*i.e.*, the value of all of the interests in the property which best reflects the value of the real property alone). The Court held that the property taxes are to be based on the value of the fee simple interest in property, not the leased fee value.

But perhaps the most important holding of the Supreme Court's decision is its affirmation of the appraisal tenet that a lease never increases the market value of real property rights to the fee simple estate. As a result, the Court concluded that "real property assessment should not be based on factors such as unusual financing or above market rent that are not normal conditions of sale reflected in the value of a fee simple property interest." The Court recognized that when assessments are based on factors such as above-market rents, in essence it is the business value of the tenant that is being taxed.

The Court's decision means that properties with above-market rents due to a sale leaseback, a development arrangement like that used by Walgreen, or some other creative financing arrangement, should not pay higher property taxes based on the resulting above-market rent. Rather, these assessments must be based on the same considerations as other properties: a recent arm's-length sale of the fee simple interest in the property or of similar properties, the income generating capacity of the property based on market rents and the cost to replace the property.

What About Below-Market Rents?

You may wonder, what if a property has a lease with below-market rents, is the assessor required to ignore the below-market rent and base the assessment on market rents? About 20 years ago, the Supreme Court, in a case called *Darcel v. Manitowoc*, held that the assessor must give consideration to below market rents when assessing a property. In fact, the City of Madison based its case on *Darcel*. While the Court rejected Madison's attempt to extend *Darcel* to situations with above-market rents, it reaffirmed *Darcel*'s holding that below-market leases



should be considered in assessing property, treating such leases as an encumbrance on the value of the property.

Of course, this decision will not necessarily be self-enforcing. Properties that are currently over-assessed will likely continue to be over-assessed unless or until an objection is filed and prosecuted. Despite the Supreme Court's decision, sales of properties with above-market rents will likely result in an initial assessment based upon an inflated, leased fee value. This is because the real estate transfer return—a key source of information for assessors—often reflects the leased fee value of a property which is subject to a lease when it is sold. Thus, it will be up to owners and tenants of real property to examine and, if necessary, challenge their assessments.

For more information on the implications to the *Walgreen* decision, contact [Don Millis](#) of the Reinhart Property Tax Team.

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