PROPERTY TAXES SHOULD REFLECT RETAIL'S APOCALYPTIC TIMES

Instead, assessors continue to ignore the clear fact that brick-and-mortar retail is in massive decline.

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The retail sector is experiencing its darkest period ever, and taxing entities must come to grips with declining shopping center values.

News reports confirm that national retailers are closing stores at a record pace. In 2017 alone, retail mainstays such as JC Penney, Sears and Macy's have shuttered hundreds of stores. Leading market analysts including Credit Suisse and Cushman & Wakefield have predicted the closing of some 10,000 brick-and-mortar stores.

Even worse, many national retailers are filing for bankruptcy protection, with several others on analysts' watch lists. The more than 300 retailers reported to have filed for bankruptcy protection in 2017 include several major brands, from Payless ShoeSource to Gymboree and Wet Seal. These dire conditions have spurred some economists to describe the ongoing bloodbath as a retail apocalypse.

Double Trouble

There are two main reasons for the retail sector's decline:

First, consumer preferences are migrating from shopping at brick-and-mortar stores to more online shopping. Online sales increased by about $40 billion in 2016 and accounted for nearly 42 percent of all retail sales growth that year. Amazon alone accounted for 53 percent of that growth, reportedly quintupling its North American sales to $80 billion in 2016 from $16 billion in 2010.

Second, today's consumers would rather spend their money on experiences than on material goods. They prefer dining out, going to movies and travel over buying more shoes, jeans, and electronics. And when they buy goods, they are increasingly likely to buy them online.

These ongoing changes in consumer behavior have resulted in a disturbingly high inventory of vacant retail space, made worse by years of overbuilding in the sector. The United States reportedly has 40 percent more retail space per person than Canada, five times more than the United Kingdom and 10 times more than Europe.

Shopping malls have been particularly affected. Once popular destinations, many regional malls now scramble to find quality tenants and to attract shoppers. To survive, some malls have taken desperate measures to steer customers to their stores, such as hosting amusement parks and concerts. Sadly, analysts predict 20 to 25 percent of U.S. shopping malls will close within the next five years. The market is simply oversaturated.

Value Questions

Consequently, retail property value has plummeted. What once was seen as a safe investment is now fraught with risk. Suffering national retailers have made retail real estate riskier as the chances of store closures and tenant bankruptcies have increased. Investors only value retail properties highly when those assets are generating a reliable stream of rental payments from high-quality tenants. But with department stores, electronics retailers and apparel shops boarding up, there is insufficient demand to sustain the rental rates and occupancy levels necessary for many properties to support historical values.

Unfortunately, tax assessors are turning a blind eye to this new reality, continuing to assume that there is a viable market with robust buyer demand for this property type.

In many jurisdictions, tax assessors have even raised taxable values on retail properties. This has obviously created confusion among property owners, as the values assessed by taxing jurisdictions conflict with selling prices that owners can garner on the open market.

When vacant properties go up for sale, they may linger on the market for years. And when they do sell, they are often sold to unconventional users, such as hospitals, trampoline parks, call centers, churches and schools. These buyers know that they can leverage the market oversupply to achieve low acquisition prices.

When owners point to sales of comparable – and often vacant – retail properties as evidence of market value, tax assessors accuse them of applying the "Dark Store Theory," which many assessors have mischaracterized as a tax loophole. Assessors have even convinced news media organizations of this misconception, evidenced by headlines such as "Sinister-Sounding Dark Store Theory Is Corporate Welfare" and "How Big-Box Retailers Weaponize Old Stores."

This has fueled an ongoing debate concerning how to properly value the fee-simple interest in income-producing property, which in most jurisdictions is the taxable value.

In essence, tax assessors claim that retail property owners are trying to escape taxation by calculating taxable value based on the asking rents and sales of vacant retail locations, rather than on actual rents and sales of occupied properties. Tax assessors contend that property owners are comparing apples to oranges.

Property owners counter that assessors are overstating real estate value by capturing the additional value of non-taxable assets, such as long-term leases with brand-name retailers.

Despite this debate, there is no hiding the fact that retail is going dark. Shopping malls and over-sized big box stores have become largely obsolete, bankruptcies and store closures plague the industry, and the glut of retail space grows. Preferences for online shopping and consumer purchasing patterns are here to stay.

We are reaching a point where the "dark store" is the norm. The market has turned previous assumptions about variables such as market exposure, vacancy, capitalization rates and market rents on their heads, resulting in a retail meltdown.

It may be difficult for many observers to watch American institutions like the shopping mall and freestanding retail center slide into obsolescence. But to maintain the integrity of our property tax system, tax assessors must accept this new reality.

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