TO: REPRESENTATIVE ROBERT BROOKS

FROM: Scott Grosz, Principal Attorney

RE: 2017 Assembly Bill __ (LRB-0373/9) and Assembly Bill __ (LRB-0372/6)

DATE: May 3, 2017

This memorandum provides an analysis of Assembly Bill __ (LRB-0373/9) (“LRB-0373/9”), relating to property tax assessments based on comparable sales and market segments, and Assembly Bill __ (LRB-0372/6) (“LRB-0372/6”), relating to property tax assessments regarding leased property, with respect to the Uniformity Clause of the Wisconsin Constitution and recent court decisions relating to taxation of property.

2017 ASSEMBLY BILL — (LRB-0373/9)

Under current law, assessors must use a three-step process in order to properly assess a property to determine its full value at its highest and best use. The first step in the process is to base the assessment on any recent arm’s-length sale of the subject property. If the subject property has not been recently sold, an assessor must next consider sales of reasonably comparable properties. If the assessor determines no such comparable sales are present, an assessor may use a “cost” or “income” assessment approach, considering all factors which have a bearing on the value of the property. [See, generally, s. 70.32, Stats.; Nestlé USA, Inc. v. Wisconsin Department of Revenue, 2011 WI 4, at pars. 25-30; and State ex rel. Markarian v. City of Cudahy, 45 Wis. 2d 683, 173 N.W.2d 627 (1970).]

LRB-0373/9, relating to property tax assessments based on comparable sales and market segments, would specify new property tax assessment practices applicable to the determination of the value of property using generally accepted appraisal methods. In particular, the bill draft specifies that an assessor must consider the following as comparable to the property being assessed:

- Sales or rentals exhibiting the same or similar highest and best use as the property being assessed, with placement in the same real estate market segment. The bill draft
defines “real estate market segment” to mean a pool of potential buyers and sellers that typically trade in properties similar to the property being assessed, including buyers who are investors or owner-occupants. The bill draft also specifies that the pool of potential buyers may be found locally, regionally, nationally, or internationally. The bill draft defines “highest and best use” to mean a use that is legally permissible, physically, possible, and financially feasible and that provides the highest net return.

- Sales or rentals of property that are similar to the property being assessed with regard to age, condition, use, type of construction, location, design, physical features, and economic characteristics, including similarities in occupancy and the ability to generate income. The bill draft specifies that such properties may be found locally, regionally, or nationally.

Additionally, the bill draft specifies that a property may not be considered as comparable if any of the following conditions apply:

- At or before the time of sale, the seller placed any deed restriction that changes the highest and best use of the property so that it is no longer comparable.

- At or before the time of sale, the seller placed a deed restriction that substantially impairs the property’s marketability.

- The property is dark property, if the property being assessed is not dark property. The bill draft defines “dark property” to mean property that is vacant or unoccupied beyond the normal period for property in the same real estate market segment and specifies that the consideration of whether a property is vacant or unoccupied beyond the normal period may vary depending on the property location.

2017 ASSEMBLY BILL — (LRB-0372/6)

LRB-0372/6, relating to property tax assessments regarding leased property, would revise certain definitions and make other changes to general assessment practices. In particular, the bill draft does the following:

- Revises the definition of “real property,” “real estate,” and “land” to include leases and other assets that cannot be taxed separately as real property, but are inextricably intertwined with the real property, enable the real property to achieve its highest and best use, and are transferable to future owners. The bill draft defines “lease” to mean a right in real estate that is related primarily to the property and not to the labor, skill, or business acumen of the property owner or tenant.

- Specifies that real property must be valued by the assessor in the manner specified by the property assessment manual at its highest and best use.

- Defines “highest and best use” for the above provision and the definition of “real property,” “real estate,” and “land” to mean the specific current use of the property
or a higher use to which the property can be expected to be put in the immediate future, if the use is legally permissible, physically possible, and financially feasible and provides the highest net return. When the current use of a property is the highest and best use, the bill draft specifies that the value in the current use equals full market value.

- Defines “arm’s-length sale” for purposes of determining value under s. 70.32 (1), Stats., to mean a sale between a willing buyer and willing seller, neither being under compulsion to buy or sell and each being familiar with the attributes of the property sold.

- In determining the value of leased real property, specifies that an assessor must consider lease provisions and actual rent pertaining to a property and affecting its value, including sale and leaseback provisions, if all such lease provisions and rent are the result of an arm’s-length transaction involving persons who are not related under Section 267 of the Internal Revenue Code for the year of the transaction. The bill draft defines “arm’s-length transaction” to mean an agreement between willing parties, neither being under the compulsion to act and each being familiar with the attributes of the property.

**WISCONSIN CONSTITUTION, ARTICLE VIII, SECTION 1**

Wisconsin Constitution, Article VIII, Section 1, commonly referred to as the “Uniformity Clause,” provides as follows:

Art. VIII, Section 1. Rule of taxation uniform; income, privilege and occupation taxes. [As amended Nov. 1908, April 1927, April 1941, April 1961 and April 1974] The rule of taxation shall be uniform but the legislature may empower cities, villages or towns to collect and return taxes on real estate located therein by optional methods. Taxes shall be levied upon such property with such classifications as to forests and minerals including or separate or severed from the land, as the legislature shall prescribe. Taxation of agricultural land and undeveloped land, both as defined by law, need not be uniform with the taxation of each other nor with the taxation of other real property. Taxation of merchants’ stock-in-trade, manufacturers’ materials and finished products, and livestock need not be uniform with the taxation of real property and other personal property, but the taxation of all such merchants’ stock-in-trade, manufacturers’ materials and finished products and livestock shall be uniform, except that the legislature may provide that the value thereof shall be determined on an average basis. Taxes may also be imposed on incomes, privileges and occupations, which taxes may be graduated and progressive, and reasonable exemptions may be provided.
The general principles of the Uniformity Clause were set forth in *Gottlieb v. Milwaukee*, 33 Wis. 2d 408, 147 N.W.2d 633 (1967). In that case, the Wisconsin Supreme Court stated that the Uniformity Clause requires that for direct taxation of property, there can be but one constitutional class. All property within that class must be taxed on a basis of equality so far as practicable and all property taxed must bear its burden equally on an *ad valorem* basis. All property not included in that class must be absolutely exempt from property taxation. The Legislature may classify property that is to be taxed and that which is to be wholly exempt and the test of such classification is reasonableness.

Constitutional analysis can be especially challenging when a constitutional test involves reasonableness. In fact, Uniformity Clause analysis has been described to require “an ad hoc, almost intuitive determination.” [Jack Stark, *The Uniformity Clause of the Wisconsin Constitution*, 76 Marq. L. Rev. 577, 619-20 (1993).] However, it is rare, historically, that a court will choose not to defer to the Legislature when the test for legislative action is reasonableness. Several courts have discussed the requirement of reasonableness in distinctions drawn in assessment of the general property tax.

In *Estate of Heuel v. State*, 4 Wis. 2d 400 (1958), the court held that uniformity means “taxation which acts alike on all persons similarly situated.” In *Associated Hospital Service, Inc. v. City of Milwaukee*, 13 Wis. 2d 447, 472 (1960), the court upheld a law that treated Blue Cross differently from other insurers, finding that real differences existed between the two classes of insurers. Nonetheless, the court also has noted that “[w]hen we are presented with a case in which the exemption is arbitrary and in which other persons of the same class owning property of the same general description are awarded exemptions of a lesser amount, the situation is one in which the rule of uniformity is violated.” [See *Board of Trustees of Lawrence University v. Outagamie County*, 150 Wis. 244 (1912).]

Similarly, a previous Attorney General has opined on the application of the Uniformity Clause to a proposed exemption of homestead property. In the opinion, the Attorney General concluded that, despite a presumption of constitutionality, it would be unreasonable to consider homestead property as “so separate and apart” from residential property used for other purposes (e.g., rental or vacation property) as distinct classes under the Uniformity Clause. [66 Op. Atty. Gen. 337 (1977).]

**ANALYSIS**

Generally, the bill drafts appear to satisfy several of the threshold inquiries with regard to the Uniformity Clause, in that the provisions of the bill drafts are created as general guidance on the assessment process, applicable to all types of property (residential, commercial, etc.) that are subject to taxation, and that the structure of taxation under the bill drafts acts alike on similarly situated taxpayers. Further, most provisions of the bill drafts may be generally characterized as legislative clarification of the long-standing statutory directives, in s. 70.32 (1), Stats., to consider recent arm’s-length sales of “reasonably” comparable property and to
consider all factors that, according to professionally acceptable appraisal practices, affect the value of the property to be assessed.

To further analyze the substantive provisions of each bill draft, it may be useful to address those provisions in sequence.

**LRB-0373/9**

**Specification of Property as Comparable**

LRB-0373/9 specifies that sales or rentals of each of the following must be considered as comparable to property being assessed:

- Sales or rentals exhibiting the same or similar highest and best use as the property being assessed, with placement in the same real estate market segment.

- Sales or rentals of property that are similar to the property being assessed with regard to age, condition, use, type of construction, location, design, physical features, and economic characteristics, including similarities in occupancy and the ability to generate income.

In support of the constitutionality of these provisions, the treatment under the bill draft may be viewed as statutory codification of principles derived from the Wisconsin Property Assessment Manual and case law.

For example, the references to “real estate market segments” and review of properties “found locally, regionally, or nationally” relate to concepts discussed in *Nestlé USA, Inc. v. Wis. Dep’t of Revenue*, 2011 WI 4. In Nestlé, the Wisconsin Supreme Court considered the assessment of an infant formula manufacturing facility, and discussed concepts relating to the specific market in which a property may be situated, as well as the assessor’s national search for comparable properties in upholding the assessor’s decision. In particular, the Court noted that an absence of recent sales does not necessarily indicate the absence of a specific market; in this case, a market specifically for infant formula manufacturing facilities relative to the market for general food manufacturing facilities.

The second provision of the bill draft, relating to the considerations for similar properties, codifies long-standing text of the Wisconsin Property Assessment Manual. [See, e.g., 2017 Wisconsin Property Assessment Manual, chapter 9, page 24.]

**Disqualification of Property as Comparable**

LRB-0373/9 specifically disqualifies the following property as comparable to property being assessed:

- Property on which the seller placed any deed restriction, at or before the time of sale, that changes the highest and best use of the property so that it is no longer comparable.
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- Property on which the seller placed a deed restriction, at or before the time of sale, that substantially impairs the property’s marketability.

- Property that is dark property, if the property being assessed is not dark property.

The principles that an encumbrance may affect the value of a property and that a property subject to an encumbrance may not be comparable to an unencumbered property are additional long-standing principles of assessment practice. [See, generally, 2017 Wisconsin Property Assessment Manual, chapter 9.] Therefore, the provisions of the bill draft to disqualify deed-restricted property as comparable may be viewed as statutory codification of another long-standing assessment practice.

With regard to the latter provision, the bill draft’s disqualification of dark property relates to a concept discussed in Bonstores Realty One, LLC v. City of Wauwatosa, 2013 WI App 131. In Bonstores, the Court of Appeals affirmed a Milwaukee County Circuit Court decision relating to the assessment of the Boston Store at Mayfair Mall. In its decision, the Court of Appeals specifically stated that it was not error for the circuit court to deem reliance on comparison to “dark” stores to be unreliable with regard to assessment of a property that itself was not dark. [2013 WI App 131 at par. 22. See, also, the 2017 Wisconsin Property Assessment Manual, chapter 13, pages 12-13.]

**LRB-0372/6**

**Statutory Incorporation of Definitions**

LRB-0372/6 incorporates into the statutes definitions of “highest and best use” and “arm’s-length sale.” This treatment codifies long-standing text of the Wisconsin Property Assessment Manual. [See, e.g., 2017 Wisconsin Property Assessment Manual, chapter 9, page 12; chapter 10; and Glossary, pages 31 and 38.]

**Determination of Value of Leased Property**

LRB-0372/6 revises the definition of “real property,” “real estate,” and “land” to include leases and other assets that are inextricably intertwined with the real property. The bill draft also specifies that, in determining the value of leased real property, the assessor must consider lease provisions and actual rent, including lease provisions and rent associated with sale and leaseback of the property, if the lease provisions and rent are the result of an arm’s-length transaction involving unrelated persons.

These provisions relate to the role of leases, actual rent, and “creative financing arrangements” in real property valuation as those terms were discussed in Walgreen Co. v. City of Madison, 2008 WI 80. While the Walgreen Court noted the legislative authority to determine the appropriate methods for valuing property for tax purposes, the Court discussed prior cases and the distinction between valuation of real property and valuation of a business concern as applied to leased property. The Court held that leased property must be assessed under the income approach in terms of market rent, rather than actual rent, unless the actual rent is lower
than market rent. The Court also cited the strict construction of tax statutes to hold that “creative financing arrangements” such as sale-leaseback transactions should be distinguished from other “ordinary” transactions for purposes of establishing property value under the applicable law. [Walgreen 2008 WI 80, at pars. 19, 54-75, and 82-85.] These provisions of LRB-0372/6 would instead specify that leases and actual rent and other inextricably intertwined assets must be considered in determining the value of leased property, to the extent the lease considered is primarily related to the property and not to the labor, skill, or business acumen of the property owner or tenant, rather than being omitted, generally, from the analysis of value under Walgreen.¹

If you have any questions, please feel free to contact me directly at the Legislative Council staff offices.

SG:jal

¹ As the Walgreen case moved through the courts, the lower courts held that the taxpayer’s claims regarding uniformity were without merit, and the Supreme Court limited its holding to the application and interpretation of the statutes and Property Assessment Manual and did not reach the uniformity issue. [Walgreen, pars. 2 and 12-14.] While not dispositive, the progression of the uniformity issue through the litigation may suggest that the issue of constitutional uniformity was of less concern to the Court than the appropriate application of legislatively prescribed valuation methods. Nonetheless, if a taxpayer were to challenge the bill draft on uniformity grounds, he or she may attempt to advance the argument that consideration of lease provisions as defined by the bill draft and actual rent, even between unrelated parties, results in assessment in excess of the “market” valuation of the property required for purposes of ad valorem taxation under the Uniformity Clause.