Walgreens and CVS Declare War on Property Taxes

How to slash your tax bill by 50 percent

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Walgreens boasts convenient locations, a wide array of products, and a killer tax strategy.

When it works, local tax officials warn, kids and homeowners suffer.

In the fall of 2012, county tax officials in Kentucky began preparing for a clash with the pharmacy chain, which operates thousands of stores in the U.S. and has a market value of more than $90 billion. Walgreens was challenging its tax assessments at stores across the state. If the company won, the assessors feared, other national retailers would follow suit, threatening the budgets of already struggling school districts.

"If you start losing the tax assessments on all of these leases, the cost is going to be hundreds of millions of dollars," said David O'Neill, the property valuation administrator in Kentucky's Fayette County.

The tax people rallied. Workers in the state's largest counties compiled a report on Walgreens' strategy and circulated it to smaller tax offices. When the Deerfield (Ill.)-based chain asked a state court to halve the taxes on a drugstore in Lexington, the assessors passed the hat. Kentucky school districts, which receive about two-thirds of property tax revenue, chipped in $26,000 so the county could afford to hire expert witnesses.

Last month, a Kentucky circuit court judge ruled in favor of Fayette County, which includes Lexington, concluding the latest skirmish in a long-running battle between national drugstore chains and tax assessors. Walgreens declined to say whether the company would appeal the ruling.

Walgreens, CVS, and other big drugstore chains have been challenging property tax assessments in courts around the country for the past decade, with little national notice. They argue, sometimes successfully, that the rent they pay their commercial landlords doesn't accurately reflect property values. When they win, they get their tax bills slashed.

Here's how it works:

Most national retailers would rather rent their stores than tie up billions of dollars in real estate. Walgreens leased 80 percent of its 8,300 stores as of August 2014, according to company filings. CVS owned just 5 percent of its 7,800 stores as of the end of last year.

The basic idea is to rent stores under contracts, called net leases, that make the tenants—the drugstores—responsible for property taxes and other expenses. To compensate the investors who sink cash into the real estate, Walgreens and other retailers pay rents that include a premium above the cost of building the store. Once the stores are occupied, net leases often trade among investors.

It’s a hefty market. About $45 billion in net leases for U.S. properties changed hands in 2014, according to Will Pike, a senior vice president at commercial real estate firm CBRE.

In tax board and judicial appeals that have sought to cut levies by more than 50 percent, Walgreens and CVS have argued that the price investors will pay to own a drugstore lease is the wrong tool for determining the tax. Instead, they say, the assessments should hinge on the amount the landlord could get if the drugstore moved out and another retailer moved in. That would lower the assessment, because the pharmacy chains have proved willing to pay higher rents than other tenants.

So the same premium that entices investors to buy the net leases gives the drugstores leverage in their tax arguments.

The chains complain that counties are taxing corporate debt instead of sticks, bricks, and mud—assessors’ slang for land and buildings.

“CVS Health is committed to being a good corporate citizen in the communities we serve and to paying our fair share of property tax,” said Mike DeAngelis, director of public relations for the company.

Walgreens, too, says it is committed to paying what's fair. “We’ve become more concerned in recent years with the use of valuation methodologies based on the value of our long-term leases in addition to the value of the real estate itself,” said spokesman Phil Caruso.

The strategy has met with mixed results. In Florida and New York, where Rite Aid has challenged its assessments, courts have rejected the net lease argument. Wisconsin has ruled in favor of pharmacies. Tax assessors scored in the Ohio courts but saw their points erased when the state’s legislature revised the tax law in the pharmacies’ favor.

More cases could be on the way. A Walgreens employee named Anna Pelts testified during the Fayette County case that the company was appealing the majority of its assessments over $3.5 million, according to legal briefs filed in the case.

Commercial property taxes fund public schools, roads, and other infrastructure in many states. Big-box stores and other national retailers have tried out the drugstores’ argument, said Tim Wilmath, a tax assessor in Hillsborough County, Fla., whose office won a state court case against CVS in 2013. But the pharmacy chains have the most at stake. That’s because of the premium they’re willing to pay for stores in busy locations, and because they lease a lot of stores, relative to other retailers.

“If they can sell the argument, they reap tremendous reward,” Wilmath said.

The Walgreens store located at 2290 Nicholasville Rd. in Lexington, Ky.

In 2005, Walgreens made a deal with a local developer to lease a drugstore on the site of a former Howard Johnson hotel on Nicholasville Road, a seven-lane thoroughfare that carries commuters past the University of Kentucky Medical Center and into the city’s downtown. Two years later, the developer sold the lease—which required the pharmacy to pay $33,500 a month for at least 25 years—to an investor for $6.3 million.

O’Neill, the tax assessor, used that price to value the store at $5.1 million in 2012. That figure was based on an agreement between Walgreens and a previous assessor to value stores below the sale price of the lease to avoid a formal appeal, O’Neill says.

But Walgreens argued that number was too high, because it included a return on investment for the developer. “Walgreens pays rent that is in excess of market because this business arrangement is, in essence, a financing mechanism,” the company argued in a legal brief.

Amid the disagreement, lawyers on both sides have sought the higher moral ground.

“In Kentucky, the school districts are hungry for money, big time,” said Robert Hill, a Maplewood (Minn.)-based lawyer who has represented both Walgreens and CVS in property tax cases. “The assessors want to make it so if you’re a national chain, you subsidize everyone else.”

Amy Seibel, a lawyer in Mequon, Wisc., who has represented tax assessors against the pharmacy chains, said homeowners can expect their tax assessments to rise as counties try to make up for lost revenue.

“The average homeowner is outraged when you tell them what’s happening,” she said.

The chains will keep fighting. Walgreens spent five years battling the tax assessment on a Madison (Wisc.) drugstore before winning a state Supreme Court judgment in 2008. In Fayette County, even if the recent ruling stands, the county probably won’t be done grappling with the pharmacy chains.

As Wilmath, the Florida assessor, put it: “Walgreens and CVS are very, very aggressive in their property tax appeals.”

—*With assistance from Michael Novatkoski*