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Can Walgreen Stance On Property Tax Hurt Income Tax Position Of 1031 Investors?

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- tax tale of why people whose real estate ships come in find themselves buying drugstores of all things
- Reilly's Second Law of Tax Planning – Sometimes, it's better to just pay the taxes.

Walgreen Co. v City of Oshkosh does not on its face seem to be a case that could have broad reaching federal income tax implications. I happen to think it may, but it may be just me. Nonetheless, my reasoning gives me a chance to explore a sub-sub industry that is kind of interesting. It is the tax tale of why people whose real estate ships come in find themselves buying drugstores of all things and perhaps an illustration of Reilly's Second Law of Tax Planning – Sometimes, it's better to just pay the taxes.

Like Kind Exchanges – Why Your Farm Is Like A Drug Store

Although Code Section 1031 (Like-kind exchanges) has applicability in many areas, real estate is probably where it shines the most. Enough so that the administration targeted Code Section 1031 in the 2015 budget proposing a $1,000,000 limit on unrecognized real estate gain. A 1031 deal is great for someone who wants to go on to bigger and better things in real estate, mainly because the like-kind concept is so broad when it comes to real estate. A cow is not like kind to a bull, but a cow pasture is like kind to an office building. Go figure.

But what about people who are tired of being landlords and are looking for passive income and no worries? Something of a sub-sub industry has sprung up to cater to successful real estate operators who want to become what Thomas Piketty would call rentiers , without paying capital gains tax . Certain major retailers, drugstores in particular, lease their stores on very long triple net leases which allow them to tap into that pool of 1031 money that is seeking very passive income.

One of the biggest players in the market is Walgreen. Walgreen has over 8,000 locations. According to The Boulder Group 169 stores were on the market in the third quarter of 2014. The properties tend to be priced based on capitalizing the net lease income. Walgreen appears to be the favorite commanding a cap rate of 5.6% as opposed to 7.4% for Rite Aid. CVS is at 5.75% When you look at price per square foot the difference is even more dramatic $457 per square foot for a Walgreen and $290 for a Rite Aid with CVS at $419.

Who Is A Good Prospect For One Of Those Deals?

It happens I know somebody who at some point was something of an ideal target for a Walgreen deal, who chose not to go that route, but his story is good to illustrate the principles involved. Full disclosure, he was a client of the various incarnations of the firms I worked for and I was involved to a greater or lesser extent in his account during that period.

Where Spag's Is Next To Leiser

The last time the words ".. . and in Shrewsbury, Mass where Spag's is next to Leiser" went out over the airwaves of Southern New England was 1989 , but the phrase is still burned into the consciousness of people alive at the time. Lesier Sound, an electronics retailer, did heavy radio advertising and after harping on whatever was latest in his stores or his price guarantee, Harry Leiser would cap the commercial by noting that there were Leiser stores in Connecticut, Rhode Island and Massachusetts including Shrewsbury Mass, where it was in fact true that Spag's was next to Leisers. The joke was that Spag's was something of a retail legend and a venerable Central Massachusetts institution. Probably more people knew where Spag's was than know where Shrewsbury, Massachusetts is.

Harry Lesier's stores in Groton, Norwich, Seekonk, Warwick, Auburn and Shrewsbury (where Spag's was next to Leiser) did pretty well. It was not very hard for Harry to figure out that owning the real estate beat renting it, so he owned most of the stores. At least in those days advisers to guys like Harry lived by a code that held that it would be better to tug on Superman's cape, spit in the wind and pull the mask off the old lone ranger than put real estate into an operating company.

So Harry owned the stores personally. Harry also picked a pretty good time to get out of retailing electronics. He sold the business in 1989, keeping the real estate, thereby becoming a pretty passive landlord. That lasted seventeen months, which is when the buyer went under, making Harry the proud owner of five vacant commercial buildings.

It was a scramble to get them rented up and for the last couple of decades Harry has had to do quite a bit of work to keep things going. There might be a period where all he is doing on one of the buildings is cashing a check, but there is always something happening with one of them. He told me that he probably works as many hours and has to apply the same level of intelligence and attention as he did when he was running the stores. He does, however, find running the real estate much less stressful and intense. Since there is no more debt he can be relaxed knowing that even if he has significant vacancy, he'll still be able to eat four meals a day.

I told Harry I was writing about the Walgreen deals and he said that he knew about them, but understood the cap rates were terrible. When I told him 5.6%, it floored him. Harry sometimes thinks that he might be getting a little too old to continue his second career as a real estate guy, that circumstances forced on him, but that abysmal cap rate will probably keep him working at least for a while. On top of that the cap rate is not the only problem with the Walgreen deals. but for that I had to talk to a couple of other guys that I have done tax work for.

Going Dark

Years ago I talked to Daryl Carter. who runs Maury L Cater and Associates , while still getting some advice from the eponymous founder, whom Daryl calls dad, about these deals.The thing that he immediately brought up was what will happen if they "go dark". Daryl thought that without the lease the buildings did not come close to justifying the price that was being paid for them.

I also reached out to Lenny Brescia. Lenny went into real estate on purpose during and after a very successful sales career. He and his spouse own a few strip malls. He has looked at Walgreen deals and besides the anemic cap rate considered that some of the leases renew at Walgreen's option in 20 years or so, which makes him think at that point he would have to deal with an empty building, that as of today would be worth roughly half of what he paid for it.

Sometimes It Is Better To Just Pay The Tax?

So I know quite a few people who either always loved real estate like Daryl and Lenny or learned to love it like Harry. They are not, however, the majority. I had a brief tenure as an accidental landlord and really came to hate it. I mean it was a two bedroom condo, how hard could that be? Hard enough. My covivant is currently struggling to sell what I used to call our country home and has taken to renting it with no great joy. So I'm thinking about what it would be like for someone in a situation similar to Harry's who was done with real estate and had say a $5,000,000 building she had decided to sell.

Let's say Mary had been running a very large hardware store and kept the real estate, which is now being rented out to whatever conglomeration of enterprises she had been able to cobble together, but has come to be too much aggravation. When she asks me about how to deal with the capital gains tax, I will of course take Code Section 1031 out of my bag of tricks. But as we look at the options many of them have aspects of jumping out of the frying pan into the fire. So I will for the sake of completeness, mention Walgreen deals.

I would probably say that it is a lot like owning a bond – a really, really long term bond, practically a perpetuity. Only if the bond gets called either because Walgreen does not renew at some point or it goes bankrupt, you get this piece of real estate, which today, without the lease, is worth maybe $2.5 million.

Now if Mary's basis is pretty high, so that the tax in question is say a couple of hundred thousand, that prospect does really not sound that great. If basis is on the low side though and there is state tax and unrecaptured 1250 depreciation and Obamacare tax from her having been passive for a while the tax could be well north of $1,000,000. Then maybe $280,000 per year looks really attractive. Only you want to be sure that the tax deferral is rock solid, which I never doubted until very recently, which finally brings us to Oshkosh.

Walgreen Admits – Nay Insists – The Building Are Not Worth That Much

Since the buildings are triple net leased the owners don't have a dog in the fight when it comes to real estate taxes, so it is Walgreen that tends to take the matter up. Now since there is such an active market for Walgreen stores, it would seem that there should not be that much to fight about. Look at the lease and divide with maybe some fancy present value math thrown in. But that's not the way it works at least not in Oshkosh, by gosh, or the rest of Wisconsin.

> In Walgreen/Madison, the court determined that where contractual rights inflate the value of leased retail property, assessors must look to the market to reach their valuations. "[A]n assessor's task is to value the real estate, not the business concern which may be using the property.".

> The circuit court found that the City of Oshkosh did not follow this rule in valuing Walgreen properties as its assessments relied on sale prices and **leases that included contractual rights that inflated the properties' values.** On appeal, the City argues that the court erred as Walgreen did not present evidence that its lease agreements increase its sale prices or provide for above-market rents when compared to other investment-grade real estate, which is the market for Walgreen properties. We affirm the circuit court's extensive, thorough, and reasoned decision. In confining Walgreen's market to one that trades in investment-grade real estate rather than looking to the broader retail market for its assessments, the City improperly valued Walgreen's business concern. *(Emphasis added)*

There were two properties one sold in 2005 for $2,923,459 and the other for $4,325,000 in 2006. The city valued them at $2,920,500 and $4,093,600 in 2010. I'm thinking that might have actually been a good deal given the way cap rates having been moving, but Walgreen was having none of it.

> Walgreen's expert appraiser, Paul Bakken, valued the Murdock property at $1,675,000 in 2009 and $1,585,000 in 2010 and the Koeller property at $1,750,000 in 2009 and $1,655,000 in 2010. He based his valuations largely on analyzing what comparable retail properties would receive in rent without considering properties leased by national credit-worthy tenants such as Walgreen. Bakken testified that he gave no weight to the prior sales of the Murdock and Koeller properties as the sale prices reflected the added value of leases with above-market rents and custom building features that would not be valued as highly by the broader marketplace. Bakken estimated the 2009 market rent at $11.50 per square foot for the Murdock property and $13.25 for the Koeller property.

The Scary Part

The court went with Walgreen, but here is the part of the decision that I find very disturbing.

> The fact that retail property may be income-producing does not render the contractual benefits of an above-market lease equal to a higher property value. A lease never increases the market value of real property rights to the fee simple estate." . Any **increase in the value of real property attributable to a particular lease constitutes contractual rather than real property right**s, even though those rights may run with the land. (Emphasis added)

Why does this scare me? Well, if I was what I refer to as the agent from hell and I was auditing somebody who had exchanged into the $4,325,000 Oshkosh Walgreen, I would be inclined to say. "You know. It looks to me like your exchange facilitator only put about $1.7 million or so into real estate as it is defined under state law in Wisconsin. The balance went into a contractual right, which is property not of like kind, making it taxable boot." Yuck.

If my fear is justified, things would not be good for the sub sub industry that has relied on the pools of 1031 money. At least one prominent expert, Charles Egerton who is a past chair of the ABA's Section of Taxation, thinks that my fears may be groundless. I do have to say though that it troubles me that people are saying that a property is worth one thing when they go to the capital markets and determine whether something qualifies for income tax deferral and something less, a lot less, when it comes to how much they have to chip in for the cops and the fire fighters and the school kiddies, but that's just me, who might have been the agent from hell, if he hadn't had the good luck to be hired by Herb Cohan.