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Commonwealth of Kentucky

Court of Appeals

NO. 2015-CA-000407-MR

WILGREENS, LLC
AND
WALGREEN CO.

APPELLANTS

v. APPEAL FROM FAYETTE CIRCUIT COURT
HONORABLE THOMAS L. CLARK, JUDGE
ACTION NO. 14-CI-01566

DAVID O'NEILL, FAYETTE COUNTY
PROPERTY VALUATION ADMINISTRATOR;
FAYETTE COUNTY BOARD OF
ASSESSMENT APPEALS, PETER BARR,
STEVE NICHOLS, AND KEITH MAYS, IN
THEIR CAPACITY AS MEMBERS OF THE
FAYETTE COUNTY BOARD OF
ASSESSMENT APPEALS; KENTUCKY
BOARD OF TAX APPEALS

APPELLEES

OPINION
AFFIRMING

** ** * * * * *

BEFORE: KRAMER, CHIEF JUDGE; JONES AND TAYLOR, JUDGES.

JONES, JUDGE: This appeal concerns a property tax assessment on commercial real property located in Fayette County, Kentucky. The Appellants, Walgreen Co. and Wilgreens (hereinafter collectively referred to as "Walgreens")¹ maintain that the Fayette County Property Valuation Administrator ("PVA") exceeded its statutory authority when assessing the subject property. According to Walgreens, the PVA overvalued the property because it took into consideration the income generated under Walgreens' triple net lease, which Walgreens asserts is above-the-market. The Kentucky Board of Tax Appeals determined that the PVA's method of assessment resulted in a reasonable estimation of the fair cash value of the property, a decision the Fayette Circuit Court affirmed.

Ultimately, we agree with the Fayette Circuit Court. While Walgreens demonstrated an alternative method for assessing the property, it failed to present convincing evidence that the PVA's assessment overvalued the subject property. The PVA's inclusion of the income generated under Walgreens' lease is consistent with KRS² 132.191(2)(b), which provides that the PVA may value property using the income generation approach by estimating the present value of "future benefits" arising from ownership of the property. For these reasons, as more fully explained below, we affirm.

¹ While "Walgreen Co." is listed as the Appellant on the notice of appeal; Walgreen Co. refers to itself as "Walgreens," and therefore, we do the same. Walgreens is the tenant of the property, which was owned during the relevant time period by Wilgreens. Pursuant to the terms of its lease, Walgreens is responsible for paying all taxes on the property. Therefore, for convenience sake, we will collectively refer to the Appellants as "Walgreens".

² Kentucky Revised Statutes.

I. BACKGROUND

The subject property, which is zoned for commercial use, is located at 2290 Nicholasville Road in Lexington, Kentucky. More than 44,000 vehicles travel Nicholasville Road each day making it a major throughway. The property is surrounded by a residential community, high-end retail stores, and is located near the University of Kentucky Medical Center, Central Baptist Hospital, and the Kentucky Health Complex. Once vacant, the property is now home to a Walgreens retail pharmacy. Walgreens does not own property; it leases it.

Walgreens entered into the lease on or about May 17, 2005. At that time, the property was owned by the Ruttenburg family. Under the terms of the lease, the Ruttenburg family agreed to oversee and finance the construction of a new Walgreens pharmacy on the property. The building had to be built to Walgreens' exact specifications. In return, Walgreens agreed to pay all real estate taxes, insurance, and maintenance costs in addition to a monthly rental fee of \$33,520.00.³ This equates to an annual rent of approximately \$404,000.00. The lease is for a period of seventy five (75) years; however, under its terms, Walgreens can terminate after an initial twenty five (25) year term and every five (5) years thereafter. The lease also gives Walgreens a right of first refusal to purchase the property outright in the event the owner decides to sell it.

³ This type of lease is often referred to as a "triple net lease." The rent is "net" to the landlord because the tenant takes responsibility for taxes, operating expenses, and the like. *See James v. C.I.R.*, 899 F.2d 905, 906 (10th Cir. 1990).

After executing the agreement with Walgreens, the Ruttenburg family hired a developer to construct the building on the site in accordance with Walgreens' specifications. Walgreens was not a party to the contract with the developer. After construction was complete, Walgreens began operating out of the site at which time it became obligated to begin paying the rent, taxes, maintenance and insurance. Around this same time, the Ruttenburg family placed the property for sale in the local and national markets. A buyer, Wilgreens, materialized and offered to purchase the property, subject to the lease, for \$6,275,000. Walgreens elected not to exercise its right of first refusal, and the property was sold to Wilgreens for that amount.

The PVA used the 2007 sale value as the assessment for 2007, 2008, and 2009. Walgreens appealed these assessments, declaring the fair cash value was no more than \$3.9 million.⁴ Prior to a hearing before the tax board, a settlement was reached wherein the PVA agreed to assess the property at \$5,250,000 for 2007, \$5,250,000 for 2008 and \$5,086,000 for 2009. Within these agreements, Walgreens concurred that the income generation approach was the proper method for valuing the property.

As required by statute, the PVA reassessed the property the following year. Again, it valued the property at \$5,086,000. It did the same for tax years 2011, 2012, and 2013. Walgreens appealed the PVA's assessed value of \$5,086,000 for tax years 2012 and 2013. The local board of assessment appeals

⁴ The lease provides that Walgreens shall have the right to appeal any tax assessment.

upheld the PVA's assessments. Walgreens appealed to the Kentucky Board of Tax Appeals ("KBTA" or "Board") declaring that the value of the property was \$4,397,600 for tax years 2012 and 2013.⁵ The KBTA held an evidentiary hearing on the consolidated matter (tax years 2012 and 2013) on August 27 and 28, 2013.⁶ Below, we summarize the evidence presented at the KBTA hearing.

Walgreens' Evidence

Walgreens called three witnesses to support its position that the PVA's assessment overvalued the property: (1) Anna Pelts, Walgreens' supervisor of tax appeals; (2) David Lenhoff, expert on appraisal theory and technique; and (3) Glenn Katz, a certified Kentucky appraiser.

Anna Pelts

Anna Pelts is the supervisor of tax appeals for Walgreens. She oversees tax assessments in fourteen states across the country, including Kentucky. Ms. Pelts testified that Walgreens leases approximately eighty percent of its 8,500 stores. Ms. Pelts testified that the lease payments under Walgreens' leases are "determined based on all the expenses associated with developing a site and building a building." This includes "the cost of the land, the construction cost of the building, any and all financial expenses, legal, architectural, and

⁵ During the course of the appeal before the Board, both parties readjusted their original assessments. After obtaining an appraisal, the PVA asserted that its original valuation was too low; the PVA asserted that the property was actually worth \$5,960,000. In turn, after obtaining its own appraisal, Walgreens argued that the declared value it filed with the Board was too high; it asserted that the property was actually only worth \$2,600,000.

⁶ At the time of the hearing, the property was back on the market and was being offered for sale by Walgreens for \$6,995,530.

entrepreneurial profit." In general, the lease payments under Walgreens' leases do not increase over the life of the lease.

If Walgreens vacates the property before the expiration of the initial lease term, it remains obligated for the rent and other related expenses under the lease. Although Walgreens has vacated properties in the past, it has never defaulted on one of its leases. Ms. Pelts testified that generally a Walgreens would not vacate a property unless it "was not a profitable location." When that occurs, Walgreens attempts to sublease the property. Second generation tenants have included dollar stores, auto parts dealers, and Goodwills. Ms. Pelts testified that typical rent for a Walgreens' location is between \$24 and \$28 a square foot whereas the second generation subleases are generally between \$8 and \$15 a square foot.

David Lenhoff

Mr. Lenhoff is a real estate appraiser and consultant. He is currently employed by SC&H Appraisal Services, a large accounting firm, where he is in charge of the appraisal practice. Mr. Lenhoff testified that he was retained by Walgreens to "to prepare to explain to the Board the appropriate methodology for valuing freestanding retail real estate." He clarified that the scope of his assignment was to explain methodology; he was not asked to and did not prepare an appraisal of the property.

Mr. Lenhoff testified that the rent generated from a Walgreens lease, or similar retailer, is "never market rent because it is never on the market." Mr.

Lenhoff explained that the goal of appraisal is to value the fee simple. If rents are considered in doing so, you must only look at market rental rates, not contract rental rates because "any increment of rent above market is--is nonreal property and it shouldn't be taxed as real property." According to Mr. Lenhoff, the lease adds a premium to the property which is not real estate subject to valuation. He elaborated further:

The income approach for real estate, regardless of whether it's a lease fee or fee simple, the income approach for real estate would just be the rent for the real estate and not any increment due to a favorable lease. So where are you going to get that rent? You can't look at other Walgreens because they were never on the market. They're never on the market, not a single one. So if you look at all these leases, and you find tons of them that are leased, they were leased in exactly the same way that the subject store was leased. It was never on the market. It's just a function of the cost and the business plan of Walgreens. So you've got a problem, where are you going to get the rents? As I stated in the articles, the best--you know, the question is--the jurisdiction gets to ask the question. We need the market value of the real property. So that's your question. So to answer that question, you have to look for rents for real property, and often that's going to be a second-generation space, space where for one reason or another what used to something else has been out on the open market and now people in traditional auction sense get to establish what the market rent is. The third issue with an income approach or the next issue with the income approach is the cap rate. What cap rate are you going to use once you the market rent or the rent for the real estate? Well, there are tons of transactions of Walgreens with leases in place. In fact, these are so attractive that often the buyers --this is a well-documented phenomenon --often the buyers never even look at the stores. They're not buying real estate, they're buying the lease and they won't even go look at it

because it's not--it isn't a real estate transaction, it's a bond transaction.

Mr. Lenhoff believes to properly value properties like Walgreens the appraiser "has to suspend reality" and understand the way that the property with the lease is being bought and sold is not reflective of the property's value in fee simple. He further explained that when attempting to quantify the market value of the property in terms of rent generation, you can look at other properties, but not if they also involve a net lease deal.

Glen Katz

Mr. Katz is a certified real estate property appraiser licensed in the Commonwealth of Kentucky. He owns his own company, Realty Solutions Company, Inc. Mr. Katz was retained by Walgreens to appraise the subject property.

Mr. Katz explained that he examined the Walgreens' lease, which based on his calculations equates to \$27.85 per square foot on an annual basis. Mr. Katz determined that the appropriate methodology for valuing this property for ad valorem tax purposes was to value the fee simple value of the land and the building. In so doing, Mr. Katz does not believe it is not appropriate to consider the income under the Walgreens' lease in appraising the property because it was a build to suit that was never exposed to the market. Likewise, Mr. Katz does not

believe that the sale approach is appropriate because "the sale price is influenced by the contract lease, it is not a reflection of market value, the fair market value of the real property, land and buildings--it is a reflection of land, building and the--the Walgreens lease." He believes considering the income associated with the lease will result in a valuation of the "lease fee" not the fee simple interest.

Mr. Katz used seven properties as comparable sales for his analysis, two of which were in other counties, and all of which were multi-tenant strip centers. These "comparable" sales did not include any properties with free standing buildings, any properties with prime tenants, or any properties located on major urban thoroughfares, like Nicholasville Road. Based on his "comparables," Mr. Katz concluded that the fair cash value of this property as of January 1, 2012, was \$2,600,000.

PVA's Evidence

The PVA presented the testimony of three witnesses in support of its valuation of the property: Justin Stevens the property assessor for the PVA; David Donan, an MAI appraiser; and James Schrader, a Fayette County real estate broker.

Justin Stevens

Justin Stevens was employed by the Fayette County PVA's office during the relevant time period. While working at the PVA, Mr. Stevens primarily valued and inspected commercial property. Mr. Stevens assessed the subject property for the 2012 tax year for \$5,086,000. He testified that he used the income approach to value the property based on the PVA's prior agreement with

Walgreens. Mr. Stevens testified that in assessing the property using the income approach, he gave Walgreens a two percent discount for management fees and the like.

David Donan

David Donan is a real estate appraiser for Valbridge Property Advisors. As a senior manager, he concentrates in commercial, industrial, and special use properties. Mr. Donan testified that he has appraised approximately 100 retail pharmacies, 40 to 50 of which were Walgreens' facilities. He typically performs these types of appraisals for banks and other lenders. Mr. Donan is familiar with triple net leases and has appraised over a hundred properties with such leases in place. Mr. Donan testified that he was retained by the PVA to provide his "opinion of what the property would sell for which is the fair cash value" as of January 1, 2012. Mr. Donan testified that his appraisal was in compliance with the Uniform Standards of Professional Appraisal Practice. Mr. Donan's opinion is that as of January 1, 2012, the property had a fair cash value of \$5,960,000. Mr. Donan testified that he used the income capitalization approach and the sales comparison approach to value the subject property. In valuing the property, Mr. Donan compared it to other Walgreens' lease sales across the nation.

James Schrader

James Schrader is a commercial real estate broker, located in Lexington, Kentucky. Mr. Schrader's firm specializes in properties located in

Fayette County, Kentucky, and he has been involved in numerous commercial transactions in the Lexington area. Mr. Schrader described why the subject property is so desirable to potential buyers, explaining that it is located on a major intersection where more than 44,000 cars pass the store each day and there is a traffic signal at the intersection. Mr. Schrader also pointed out that the subject property is bought and sold on a national basis. Anyone interested can access the internet and find properties like this across the United States.

Mr. Schrader explained that the determination of value for this property would be what a willing buyer would pay a willing seller. He said a potential buyer would analyze the current income from the lease, would look at the number of years left on the lease and the credit strength of the lessee (tenant). He would also look at the local market conditions to see the rents and if rents are going up and down in the area. Mr. Schrader expressed his opinion as to the fair cash value based on his knowledge as a commercial real estate broker and someone who is active in the market place with respect to these types of properties. He opined that the subject property had a value on January 1, 2012, of between \$5.8 million and \$6.1 million. He expressed that this opinion as to the value would apply for 2013 as well.

Mr. Schrader pointed out that comparable sales of similar properties along Nicholasville Road supported this market value. He explained that Trader Joe's located at 2326 Nicholasville Road is nearly the same size as Walgreens'

store.⁷ Even though the Trader Joe's store is not on an attractive corner light like Walgreens' store, it sold for \$6,354,662.00 in 2012.

Ultimately, the KBTA concluded that Walgreens failed to meet its burden of showing that the property was overvalued by the PVA. The Board found that the gross sales price of the property in 2007, along with the taxpayer's own more recent asking price, served as support for the PVA's valuation of this property at \$5,086,000.⁸ The Board explained:

The existence of a long-term, build-to-suit lease on a commercial property adds measurable value to that property which must be taken into consideration by the property valuation administrator when assessing the property, under either the sales comparison approach or the income approach to value.

Properties with build to suit leases must be assessed for the amount of money that they will bring at a fair voluntary sale, because that is the sole standard of assessment under the Constitution. The Kentucky Court of Appeals has also previously recognized the importance of considering the type of tenant, its financial stability, and the duration of a lease when using an income approach to valuation.

All parties agree that the Walgreen's lease is a valuable one and the taxpayer's own asking price for the property reflects that value. By the restrictions on this property, this property must be sold subject to that valuable long-term lease, yet the taxpayer argues that the existence of the lease must be completely disregarded for property tax

⁷ Trader Joe's is a national grocery store chain.

⁸ The Board found that the testimony of Mr. Schrader and Mr. Donan concerning the use of Walgreen's actual rents in an income approach as market rents supported the PVA's assessment. However due to Mr. Donan's failure to fully explain the difference between his value and the PVA's assessment and his failure to use local sales and income information, the Board did not place his higher value upon the property.

valuation purposes and that the amount that an investor pays for that property with the lease is not the fair cash value of the property. This Board concludes that so long as Walgreen's remains the tenant, the fair cash value for the property must include the value that is added to the property from the lease that encumbers that property. In the same manner that the restrictions of a subsidized low-income apartment complex must be considered by the assessor in the valuation of such an apartment complex, it was proper for the PVA to consider the actual rental rates for this property which was encumbered by a build-to-suit lease, and the financial stability of that long-term tenant in his income approach to valuation for the property. It would also be appropriate for a PVA to consider rents and sales of similarly improved properties with build-to-suit leases, when assessing a property with a build-to-suit lease. The PVA's method of assessment resulted in a reasonable estimation of fair cash value. The taxpayer failed to show that this property has been overvalued beyond its fair cash value and the assessment of \$5,086,000 is upheld for the 2012 and 2013 tax years.

Properties with long-term build-to-suit leases in place have, in effect, become their own subclass of real property and a market has come into existence for such properties, both locally and nationally. As the witness for Walgreen's explained, Walgreen's properties with build-to-suit leases are more valuable than vacated Walgreen's properties without build-to-suit leases. The market for these properties reflects this additional value through the rents and the sales prices and the assessment for these properties must reflect that market in order to fulfill the fair cash value requirements of the Kentucky Constitution.

This Board has ruled that the existence of a build-to-suit lease on a property enhances the value of the real property and this enhancement cannot be disregarded in a fair cash value determination. It appears, that what Walgreens is advocating for in this appeal, is a deduction to be made from the sales price of its property, based upon the "entrepreneurial value" associated with its build-to-suit Walgreen's lease. As the PVA points out in

his brief, if the taxpayers seek such an absolute deduction for properties with build-to-suit leases, they will have to seek it from the General Assembly.

Appellants appealed to the Fayette Circuit Court. By order entered February 18, 2015, the Fayette Circuit Court affirmed the KBTA. This appeal followed.

I. STANDARD OF REVIEW

One aggrieved by a tax assessment may appeal to the KBTA. *See* KRS 131.340(1) ("The Kentucky Board of Tax Appeals is hereby vested with exclusive jurisdiction to hear and determine appeals from final rulings, orders, and determinations of any agency of state or county government affecting revenue and taxation."). The KBTA's "function is not simply to review the action but to try anew the issues as presented." *Jefferson Cnty. Prop. Val. Adm'r v. Oxford Prop., Inc.*, 726 S.W.2d 317, 319 (Ky.App. 1987) (*citing* KRS 131.340(1)).

Judicial review of the KBTA's decision is governed by KRS Chapter 13B. *Louisville Edible Oil Products, Inc. v. Revenue Cabinet Com. of Kentucky*, 957 S.W.2d 272, 273 (Ky.App. 1997). The standard of review appears in KRS 13B.150(2) as follows:

The court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact. The court may affirm the final order or it may reverse the final order, in whole or in part, and remand the case for further proceedings if it finds the agency's final order is:

(a) In violation of constitutional or statutory provisions;

- (b) In excess of the statutory authority of the agency;
- (c) Without support of substantial evidence on the whole record;
- (d) Arbitrary, capricious, or characterized by abuse of discretion;
- (e) Based on an ex parte communication which substantially prejudiced the rights of any party and likely affected the outcome of the hearing;
- (f) Prejudiced by a failure of the person conducting a proceeding to be disqualified pursuant to KRS 13B.040(2); or
- (g) Deficient as otherwise provided by law.

Id.

KRS 13B.150(2) makes clear that in reviewing the decision of an administrative agency, a reviewing court does not perform a *de novo* review except as to pure legal issues. With respect to factual disputes, the reviewing court must uphold the agency's decision if there was substantial evidence of probative value upon which the agency could base its decision and the agency applied the correct rule of law to the facts before it. *Kentucky Unemployment Ins. Comm'n v. Murphy*, 539 S.W.2d 293, 294 (Ky. 1976). “[S]ubstantial evidence’ means evidence of substance and relevant consequence having the fitness to induce conviction in the minds of reasonable men.” *Owens–Corning Fiberglas Corp. v. Golightly*, 976 S.W.2d 409, 414 (Ky.1998).

II. ANALYSIS

The Kentucky Constitution and KRS 132.690 require that non-exempt property be assessed annually at its *fair cash value*. Section 172 of the Kentucky Constitution states that:

[a]ll property, not exempted from taxation by this Constitution, shall be assessed for taxation at its fair cash value, estimated at the price it would bring at a fair voluntary sale; ...

Id. "Kentucky courts have recognized in several cases that the level of accuracy achieved by a private fee appraiser in valuing a property cannot practically be achieved by the state tax assessor nor is such accuracy even required by Section 172 of the Kentucky Constitution, which specifically provides that fair cash value will be 'estimated'." *Revenue Cabinet, Com. of Ky. v. Gillig*, 957 S.W.2d 206, 209 (Ky. 1997). "The proper criterion of fair cash value for any property . . . is the price the seller willing but not forced to sell would take and the buyer willing but not forced to buy would give for it." *Kentucky Tax Commission v. Jefferson Motel, Inc.*, 387 S.W.2d 293, 296 (Ky. 1965).

"The determination of fair market value is a difficult task, and, except in rare circumstances, the final decision is at best an educated estimate." *Harlan County Bd. of Sup'rs v. Black Star Land Co.*, 392 S.W.2d 40, 42 (Ky. 1965).

"Regardless of the manner or method used by the Property Valuation Administrator or the decision of the Kentucky Board of Tax Appeals, the finding of valuation must be its fair cash value, estimated at the price it would bring at a

fair voluntary sale." *Helman v. Kentucky Bd. of Tax Appeals*, 554 S.W.2d 889, 891 (Ky.App. 1977).

The law of Kentucky grants the estimated property tax assessment a presumption of validity and places the burden of establishing that the assessment is incorrect on the taxpayer. *Gillig*, 957 S.W.2d at 210. To prevail, the taxpayer must "establish that the assessment was wrong, and if there is testimony of competent valuation witness/es in support of the assessment, even though conflicting, a finding adverse to the taxpayer cannot be set aside as clearly erroneous." *Jefferson County Property Valuation Adm'r v. Ben Schore Co.*, 736 S.W.2d 29, 30 (Ky.App. 1987). Additionally, our courts have long held that an assessment cannot be attacked based solely on methodology. *Fayette Cty. Bd. of Sup'rs v. O'Rear*, 275 S.W.2d 577, 579 (Ky. 1954).

Throughout this appeal and the proceedings below, Walgreens has repeatedly focused its attention on the fact that the rents it usually agrees to pay are "above market." But, when put to the task of valuing the subject property, Walgreens attempted to show this property was overvalued by relying on properties very different from the present. None of the properties Walgreens relied on is located on Nicholasville Road or anywhere similar. Walgreens compared apples to oranges. Its failure to produce competent, substantive evidence in and of itself justified the Board's conclusion. In short, Walgreens did not meet its initial evidentiary burden. Without competent evidence establishing overvaluation, Walgreens had no case. *O'Rear*, 275 S.W.2d at 579 ("We think the assessment

here had sufficient prima facie validity to require it to be upheld in the absence of a showing by the taxpayer that the assessment exceeded the fair voluntary sale price.”). Walgreens had the burden of showing that the PVA’s valuation of \$5,086,000 overvalued the property. The Board found that Walgreens failed to meet that burden. We agree.

Even setting aside the proof issue, we can find no outright fault with the PVA’s application of the assessment statutes. The PVA’s job is to estimate “fair cash value.” In doing so, the PVA is permitted to use the income generation approach. Our General Assembly has defined the income approach as “a method of appraisal based on estimating the present value of *future benefits* arising from the ownership of the property.” KRS 132.191(2)(b). A “benefit” is defined by *Black’s Law Dictionary* as: “1. The advantage or privilege something gives; the helpful or useful effect something has <the benefit of owning a car>. 2. Profit or gain; esp., the consideration that moves to the promisee <a benefit received from the sale>.” Black’s Law Dictionary (10th ed. 2014). Therefore, under the statute, in using the income generation approach, the PVA is permitted to take into account the present value of all advantages arising out of ownership of the property. The General Assembly has not carved out any certain type of benefit as requiring exclusion. The statutory language persuades us that the PVA did not err in its valuation of the property in question as the payments under the leasehold are undisputedly benefits that arise out of the ownership of the property.

Moreover, we do not believe that consideration of the leasehold is a

novel concept. In *Helman v. Kentucky Bd. of Tax Appeals*, 554 S.W.2d 889, 891 (Ky. App. 1977), we explained how the PVA should consider rental income in relation to fair cash value. We held as follows:

The true income approach to fix fair cash value is a valid one and income from or ***rental value of real property is a proper factor to be considered in fixing its valuation for tax purposes.*** However, the courts throughout the United States are in complete agreement that income or earnings are neither the only element nor the controlling element to be considered in determining the valuation of realty for tax purposes. See *Commonwealth, et al. v. J. B. Clay & Company*, 215 Ky. 125, 284 S.W. 428 (1926). A number of other elements necessarily enter into the value, ***such as original cost, location, cost and character of improvements, rental history, location as to future growth of the adjacent area, sales of adjacent property, sales of comparable property, type of building or property, etc.***

Where the income approach is used, all jurisdictions, including Kentucky, require that net income and not gross income be the factor. ***Other considerations are the terms of the lease, such as requirements for maintenance, alterations or improvements, fixed rent or percentage of sales; prospective earnings as well as past earnings; length or duration of the lease; options at increased or decreased rentals; and, of considerable importance, the type of tenant and his financial stability.***

Id. at 891(emphasis added).⁹

⁹Additionally, we cannot agree that the law in our Commonwealth's supports Walgreens' position that the bundle of rights associated is intangible personal property. The lease attaches to the real estate. "A lease is but a conveyance of an estate in realty. It divests the owner, for a given time, of a certain estate in the realty, leaving in him the reversion." *Mattingly's Ex'r v. Brents*, 159 S.W. 1157, 1160 (Ky. 1913). "[T]he proper criterion of fair cash value for any property, including a leasehold, is the price a seller willing but not forced to sell would take and a buyer willing but not forced to buy would give for it. And that figure may or may not approximate the value of the lessee-added improvements, depending on the circumstances." *Kentucky Tax Comm'n v. Jefferson Motel, Inc.*, 387 S.W.2d 293, 296 (Ky. 1965). "When the lessor is not tax-exempt he bears the incidence of ad valorem taxes on the entire value of the property as a whole,

Indeed, it seems based on the PVA's proof, that this property by virtue of its highly desirable location is capable of generating the kind of income derived under the lease. This is illustrated by the fact that several of the properties located in the same area, such as Trader Joe's generate similar benefits for their owners. In short, one of the reasons this property is worth so much is the same reason Walgreens wanted to occupy the space--it is in a great location. As the old saying goes, "it's all about location, location, location."

Further, we are not persuaded by Appellant's reliance on *Commonwealth, Department of Highways v. Sherrod*, 367 S.W.2d 844 (Ky. 1963). *Sherrod* was a condemnation action in which part of the parcel taken was leased for commercial use (drive-in restaurant and parking lot) and a portion had a residence and farm buildings utilized by the owner. The issue in *Sherrod* concerned damages for the taking of individual portions of a property which exceeded the fair market value of the property as a whole. The *Sherrod* court concluded that the favorable lease applicable to the *Sherrod* property represented a profit for which the landowner "was not entitled to be compensated in a condemnation proceeding." *Id.* at p. 849. Like the circuit court, we reject Appellant's reliance on *Sherrod* because a damages issue in a condemnation case is inapposite and unpersuasive to our analysis of the case before us.

Appellants argue that *Kentucky Dept. of Revenue v. Hobart Mfg. Co.*, 549 S.W.2d 297 (Ky. 1977), renders the principles in *Sherrod* applicable here and he passes it on to the tenant through the rental rate agreed upon between them." *Id.* The point being, the tax authority still collects a tax on the full value of the property. *Id.*

because *Hobart, supra*, stated that the formula in *Sherrod* worked well in condemnation cases, and there was no reason it would not work well in taxation cases. We believe that the *Hobart* case actually works against Appellants. The *Hobart* court found that “the leasehold is taxable as real estate at its fair cash value.” *Id.* at 299. The *Hobart* court interpreted Kentucky law stating that a lease can be considered when determining tax value of an income producing property. The only reason that the leasehold in *Hobart* had to be separated from the property was because the property itself was tax exempt. We are not dealing with tax exempt property, and therefore, we find no reason to separate the lease from the property. The lease is a part of the property and should be valued as such.

Walgreens wants a hard and fast rule that we cannot give it.

Essentially, it wants us to say that its leases, as a whole, do not reflect true market value. It is for the PVA, not us, to determine fair cash value by assessing each individual property. Net rental income can be considered in doing so as well as other factors, including the tenant's creditworthiness. In certain situations, the passage of time or change in location demographics may make the income approach inappropriate because it will distort the value of the property--this could be an increase or a decrease in value. In this case, however, we do not believe that the PVA's chosen measure of assessment distorted the value of this property. The property with or without the Walgreens' store is capable of generating substantial income for its owner as reflected by other similar properties on the same road. The fact that the property is able to generate such income makes it more valuable.

Walgreens is not stuck with the valuation for perpetuity. If conditions change at some point in the future, we must presume the PVA will take those conditions into consideration. The property is subject to reassessment each year. If at some point, it is no longer desirable to first tier tenants like Walgreens, then the value may have to be adjusted downward. That is not our reality today. To interpret the tax assessment statute as requiring valuation of property in a hypothetical unencumbered form ignores the economic realities of commercial real estate transactions and disregards the General Assembly's decision to include consideration of the present value of all future benefits when using the income approach to property valuation.

III. CONCLUSION

We affirm the order of the Fayette Circuit Court upholding the KBTA's ruling.

ALL CONCUR.

BRIEF AND ORAL ARGUMENT
FOR APPELLANTS:

Michelle M. Whittington
Frankfort, Kentucky

AMICUS CURIAE BRIEF FOR
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