

## What's New in Residential Transactions?

When wise King Solomon said, "There's nothing new under the sun"<sup>1</sup> he was *not* referring to today's residential transactions. This article discusses several new, and not so new, risks and opportunities for an attorney representing a client buying or selling a house. There is a fine line between being a hero to your client and a defendant in an ugly malpractice action.

Most home sales still start with a purchase agreement. The seller wants the buyer's money. The buyer wants the seller's house. The buyer inspects the house (we hope!) and obtains a mortgage (or two). A title company closes the transaction, and everybody's happy. Right? Well, maybe.

This article discusses several new, and not so new, risks and opportunities for an attorney representing a client buying or selling a house. Stated another way: the fine line between being a hero to your client and a defendant in an ugly malpractice action.

### Where to Start?

Start with a signed retainer agreement and retainer fee. Provide your client a clear understanding, preferably in writing, of the scope and anticipated cost of your legal services. Each transaction is different. The scope of representation depends in part on who you represent; whether one or more real estate brokers/agents are involved; the ability of those brokers/agents; what documents you will draft, or review; your role in helping the client address mortgage loan, title and property related issues; the role of the title company; whether or not you attend the closing; the cost of the property; and, of course, what problems you encounter along the way.

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## **Don't Simply Rely on a "Standard Form" Purchase Agreement**

In Michigan, there is no one standard form. There are hundreds of standard forms. Each one is different. Most forms have fill-in-the-blank common terms and conditions such as parties, price, property, time to satisfy inspection and mortgage contingencies, amount financed, amount of good faith deposit, closing date and surrender of possession (will seller continue to occupy the property and pay rent for a short period of time after closing?)

If you start with a pre-printed form, consider drafting an addendum to the contract. In representing the buyer, you may want to include: (a) seller representations (and warranties) above and beyond those in the statutory Seller's Disclosure Statement;<sup>2</sup> (b) the right to obtain a satisfactory survey; (c) the right to approve all matters of title and survey, including the legal description and encumbrances; (d) the right to receive enhanced title insurance protection, such as the new ALTA 2006 owner's title policy, a title insurance policy "without standard exceptions," or the ALTA homeowner's expanded coverage policy (discussed below); (e) an appraisal contingency to confirm the current fair market value is not less than the purchase price, especially if it's a "for sale by owner," or FSBO, transaction, or the buyer does not have a mortgage contingency; (f) the right to terminate the agreement for any reason during the inspection period; (g) limiting the buyer's liability to loss of the deposit if the buyer defaults (no specific performance against the buyer); (h) responsibility for payment of any outstanding special assessments; and (i) the right to perform environmental or additional inspections.

## **Your Client Can Never Over Inspect**

If you represent the buyer, recommend hiring an experienced, independent professional to thoroughly inspect the property.<sup>3</sup> The buyer should not hire a friend or relative of the listing agent. In Michigan, inspectors are not licensed or registered. If the buyer asks for a recommendation, offer

at least three names. If the inspector you refer does a poor job, the buyer might sue you for negligent referral. In any event, do not simply rely on the Seller's Disclosure Statement, a Lead Paint Disclosure and any seller representations or warranties contained in the purchase agreement. Consider specialized inspections, tailored to address specific issues, such as roof or basement water issues; structural integrity; breezy or leaky windows; built in pools; septic tanks; well water; water access for homes on or near a lake; lead paint for houses built before 1978; asbestos; radon; black mold; and other environmental concerns. Due diligence for water-front property, especially inland lakes, may include a test for the condition and health of the body of water, and a quick call to the appropriate regulatory agency. Turn over as many rocks as possible and see what crawls out from under them.

If you represent the seller, consider a pre-sale inspection. This is required in the City of Detroit, and some surrounding cities. This helps keep the property up to code and reduce issues that may arise later.

### **What About Non-Physical Due Diligence?**

Make sure your client considers "non-physical" due diligence. Speak with the homeowner's association President, to ferret out problems. Is there a lawsuit with the developer over defective or incomplete common area improvements? Speak with neighbors to determine if they seem naughty or nice. Get acquainted with the surrounding areas – next to a spooky cemetery, dangerous shooting range or smelly waste dump? Review recorded condominium documents, or easements and building and use restrictions, for potential issues, especially with vacant land or new construction. Talk with city or township officials and review pertinent public records regarding the property, such as permits (or lack thereof), certificates of occupancy, assessor valuation records

including square footage, and tax bills. This may smoke out other issues such as zoning or code violations or anticipated special assessments.

Some homes suffer from a “psychological defect.” Was the home a drug den or house of ill repute? Were prior occupants the victims of a brutal axe murder? These facts may not describe the property’s physical condition, yet, most buyers would want to know in advance.<sup>4</sup>

### **Get a Survey**

Suggest your client obtain a survey. Many mortgage lenders require a basic “mortgage report” survey, which is certified only to the lender, so your client cannot rely on it. Mortgage surveys fail to show property lines, easements or encroachments with any certainty. Sometimes, a mortgage survey is sufficient, sometimes not. It depends upon the property. A mortgage survey may be sufficient for a house in an established platted subdivision with fenced yards where the client is not concerned about actual property lines. On the other hand, if the land includes acreage, potential property line issues or encroachments, or recorded easements not visible upon casual inspection, or if the legal description raises red flags, then recommend your client obtain a better quality survey, before deciding whether to close.

Some clients should consider obtaining a boundary survey, or a more deluxe ALTA/ACSM survey. The “top of the line” ALTA/ACSM land title survey meets minimum standard detail requirements established jointly by the American Land Title Association and the American Congress of Surveying and Mapping, and offers a wealth of important information about the property.

## What's New in Title Insurance?

While all buyers should obtain title insurance, policies differ. First, suggest your client obtain (or provide) the new form 2006 ALTA Owner's Policy, which contains a number of consumer oriented title coverages and protections not offered under the prior 1992 ALTA Owner's Policy.

Second, recommend that the buyer obtain an owners policy "without standard exceptions." While a title policy insures ownership, it "excepts" or excludes coverage for certain "standard" matters such as: unrecorded claims or interests ascertainable upon physical inspection, unrecorded easements, adverse circumstances that would be disclosed by an accurate survey, and unrecorded construction liens. Title companies typically insure against these "excepted" matters upon receipt of an affidavit from the seller, and a satisfactory survey. Some title companies will accept a mortgage survey, others require a better survey.

Third, if you have any doubts about the title agency handling the transaction, ask for a closing protection letter. A closing protection letter is a letter issued by the title agent's underwriter. It "protects" the buyer (or lender) against the title agent's fraud, negligence and errors.

Finally, consider the deluxe, expanded coverage 1998 Homeowner's Policy of Title Insurance. Different title companies have different names for this product, and often, charge an additional premium. But, it may be worth it. The policy covers select problems which arise for the first time *after* closing, such as post policy forgeries, encroachments by neighbors, and structural damage from mineral rights extraction. The policy provides coverage if the prior owner violated building permits, restrictive covenants, zoning or subdivision laws. The policy offers enhanced coverage for vehicular and pedestrian access, and continued protection where the buyer transfers title to their living trust after closing. The policy amount increases 10% per year for the first five years after closing. In short, this policy lets the parties shift potential title-related risks to their friendly, neighborhood title company, and their underwriter.

## **What's New in New Construction?**

The Michigan Construction Lien Act was recently amended to better protect homeowners against construction liens, where the homeowner pays their builder/general contractor, but the general contractor fails to pay subcontractors, laborers or suppliers.<sup>5</sup> The owner or their designee named in the notice of commencement now has a duty to notify subcontractors, laborers and suppliers listed in the sworn statement - either in writing, by telephone or personally - that they have received the sworn statement, and provide each potential lien claimant a copy of the sworn statement upon request.<sup>6</sup> To facilitate this, sworn statements now must include the address and telephone number of each person listed.<sup>7</sup>

In addition, an owner or their designee may no longer rely on a lien waiver delivered by a person other than the potential lien claimant, unless the owner first verifies its authenticity directly with the potential lien claimant, either in writing, by telephone or personally.<sup>8</sup> To make life easier (and harder), these new requirements appear directly on the new forms of sworn statement and construction lien waivers.<sup>9</sup> The goal is to facilitate communication and verification of contractor, lien waiver and payment information, in order to reduce nonpayment situations, construction liens and costly litigation.

New construction presents significantly more risk than the purchase of an existing house, where you see what you get (except for latent defects). With new construction, buyers need to consider issues such as: Who has title and when does title transfer; what if the house does not get built at all, or on time and within budget; construction liens; what features and work are included and excluded; financing the construction and purchase; change orders (oral and written); incomplete or defective work; negotiating (or failing to negotiate) unreasonable pro-builder provisions out of the purchase contract; disputes with the builder; and the builder's insolvency or bankruptcy. What can you do to help? Draft a contract addendum with important checks and balances on title,

construction and money matters. Make the builder satisfy certain conditions precedent before receiving interim “draws” and final payment. Require periodic inspections and a rolling punch-list which is continually updated as incomplete, defective or non-conforming work is completed throughout construction. Establish a holdback or escrow at closing for minor, incomplete punch-list items. Require the builder to provide sworn statements. Obtain lien waivers to substantiate receipt of payment by subcontractors, laborers and suppliers who could record a construction lien against the property. Include a reasonable warranty. Fix a firm completion date and per diem penalty for late completion, to be deducted from the purchase price at closing. A well drafted addendum will help your buyer client manage and minimize some of the risk inherent in new construction.

### **What is FIRPTA?**

If the seller is a “foreign person” then the transaction is subject to the U.S. Foreign Investment in Real Property Tax Act of 1980 or “FIRPTA.”<sup>10</sup> FIRPTA ensures that foreigners who invest in U.S. real property pay their fair share of taxes here in the United States. If the transferor is a foreign person, then the buyer must deduct and withhold 10% of the purchase price, unless an exemption applies.<sup>11</sup>

One common exemption to FIRPTA withholding, is where the buyer purchases property for use as their personal residence and the purchase price does not exceed \$300,000.<sup>12</sup> If the purchase price exceeds \$300,000, then the buyer must have the seller furnish a non-foreign affidavit and certify, under penalty of perjury, the seller’s name, address, U.S. taxpayer identification number, and that the seller is not a “foreign person.”<sup>13</sup> If the seller fails or refuses to do so, then the buyer must withhold 10% of the purchase price or risk incurring liability for failure to withhold.<sup>14</sup>

## **What's a "Short Sale"?**

A "short sale" occurs when a mortgage lender agrees to accept less than the total amount owed and releases the borrower from the remaining unpaid indebtedness. With Michigan's unemployment rate being second highest in the nation,<sup>15</sup> and the real estate market values declining, foreclosures have skyrocketed. Many mortgage lenders would prefer to receive a substantial lump sum payment, and move on, instead of foreclosing, acquiring title to the property, and dealing with all the headaches associated with listing the property for sale, finding a new buyer, and maintaining the property in the interim.

How does a short sale work? Assume in 2004, the homeowner purchased their home for \$300,000. Today their mortgage balance is \$270,000 but the property is worth only \$250,000. If they sold their home for \$250,000, the lender would be "short" \$20,000, yet agree to accept the net sale proceeds as payment in full. Lenders are more inclined to accept a short sale and write off the balance of the debt if the homeowner proves financial hardship and provides a fair market value appraisal. The disadvantages to a homeowner include: (a) loss of any possible equity in their home, (b) late payments are reported to credit agencies, and (c) potential income tax liability for discharge of indebtedness equal to the difference between the total amount owed and the payment accepted by the lender.<sup>16</sup> Income from the discharge of indebtedness is excluded from gross income if discharged through bankruptcy, to the extent a taxpayer's liabilities exceed the fair market value of their assets, or for certain debt incurred in connection with real property used in a trade or business, secured by the real property, and for which an election is made by the taxpayer.<sup>17</sup>

## **What's a Reverse Mortgage?**

A reverse mortgage is a loan transaction where the lender makes monthly "payments" (loan advances) to the borrower. Reverse mortgages are ideal for older homeowners who are home rich

and cash poor. It lets them turn the equity in their home into cash without selling their home.

Consider this tool for senior clients in search of creative ways to help finance their golden years.

There are three types of reverse mortgages: (1) single-purpose, such as, home improvement, paying tax bills or financial hardship; (2) federally insured, also known as Home Equity Conversion Mortgages (“HECM”) which are backed by the U.S. Department of Housing and Urban Development and can be used for any purpose; and (3) proprietary, which is a private loan backed by companies that develop them for the same purpose as HECM.<sup>18</sup>

Often the homeowner has the flexibility to decide how to receive the cash. They may either receive monthly installment payments, one lump sum, a credit line to be used as the need arises, or a combination of the three.<sup>19</sup>

The main differences between a traditional home equity loan and reverse mortgage are the requirements for approval and repayment. To obtain a home equity loan, lenders consider equity in the home, and the borrower’s income and ability to repay the loan. With a reverse mortgage, the borrower must be at least age 62 and live in their home. Lenders also consider the type of reverse mortgage, current interest rates and the home’s appraised value. A home equity loan is often repaid in periodic installments of interest only and optional principal payments. A reverse mortgage is typically not repaid until the homeowner dies, sells their home or permanently moves out.<sup>20</sup> Reverse mortgage loan advances are not taxable as income to the homeowner, and generally do not affect Social Security or Medicaid benefits.<sup>21</sup>

### **Fraud, Anyone?**

The FBI considers mortgage fraud the “fastest growing white collar crime.”<sup>22</sup> Mortgage fraud takes many forms and is limited only by the creativity and ingenuity of perpetrators. If a deal smells fishy, look for “red flags.” Something out of the ordinary. Use your judgment and keen

observation. Ask questions until you are satisfied with the answers. Does the purchase price suddenly increase? Is the seller taking back a “disappearing” second mortgage to provide the buyer with “equity” necessary to secure a first or second mortgage loan based on the higher purchase price? Does the HUD-1 Settlement Statement show unusually high fees or payments to third parties? Are there any recent quit claim deeds in the chain of title? These are just a few of many possible warning signs of fraud.<sup>23</sup> An ounce of prevention can save your client from being pounded by mortgage fraud.

### **To Uncap or Not to Uncap?**

In a typical residential transaction, there is a statutory “transfer of ownership.”<sup>24</sup> The property’s taxable value will “uncap” or “pop up” to a higher state equalized value. The purchaser’s real estate taxes increase, often significantly, beginning the following year, due to the property’s higher taxable value. Purchasers have a duty to report the sale – and purchase price – to the local assessor by filing a Property Transfer Affidavit within 45 days after closing.<sup>25</sup>

Can you legally structure the transaction to avoid uncapping the property’s taxable value? In a typical sale, no. But, with certain non-traditional “exempt” situations, yes. When a husband deeds property to his wife or includes her on title, that does not uncap the property’s taxable value.<sup>26</sup> Taxable value does not uncap when a grantor transfers property to their revocable living trust; retains a life estate or life lease; creates or ends a joint tenancy if at least one of the grantees was an original owner; effects a foreclosure or forfeiture; or transfers property to an entity under common control or part of an affiliated group.<sup>27</sup> On the other hand, transfer of a majority interest in a private corporation or limited liability company that owns real estate is (with certain exceptions) a transfer of ownership which *does* uncap the property’s taxable value, even though there is no deed, and no transfer of title to real property.<sup>28</sup> Under these circumstances, the recipient of the majority interest

in the business entity has a duty to file a Property Transfer Affidavit, report the transfer of ownership and suffer an uncapping of the property's taxable value. Always check the statute and related guidelines to see whether the transfer constitutes an uncapping transaction.

### **When is a House Not an Exempt Principal Residence?**

Real property taxes are based on two components: value and rate. The value component, the taxable value, is discussed above. The (millage) rate component varies depending upon whether or not the property is taxed as a homestead. Homeowners who own and occupy a property as their principal residence and file a Homeowner's Principal Residence Exemption Affidavit with their local assessor, will enjoy an exemption from a portion of their local school operating taxes,<sup>29</sup> and are taxed at the lower "homestead" rate. When someone sells their home or ceases to occupy property as their primary residence, they have a duty to file an affidavit rescinding their principal residence exemption.<sup>30</sup> A buyer then must file their own (new) Homeowner's Principal Residence Exemption Affidavit.

What about related party transactions? If a parent deeds their home to their children, and retains a life lease or life estate, the parent may still continue to claim a homestead exemption for the property, even though they do not legally own it.<sup>31</sup> Under certain circumstances, a husband and wife can claim two separate homestead exemptions for two different residences, as long as each occupies a separate home as their principal residence.<sup>32</sup> As with uncapping, consider opportunities for lawfully preserving or claiming a homestead exemption when handling estate planning, related party or oddball transactions.

## What About Real Estate Transfer Taxes?

Michigan has two real estate transfer taxes. The county tax of \$.55 per \$500 of value,<sup>33</sup> and the state tax of \$3.75 per \$500 of value.<sup>34</sup> Both taxes combined equal .86% of the purchase price. In a typical sale, the seller pays these taxes. Query: is there something unusual about the transaction that may exempt the transfer from either or both transfer taxes? Many attorneys know about the exception when the value of the consideration is less than \$100.<sup>35</sup> Lesser known exemptions apply to transfers where the grantor is a government entity; transfers of leasehold interests; transfers between spouses; judgments or court orders (except where monetary consideration is specified); instruments used to straighten boundary lines or confirm title already vested in a grantee; land contracts; mineral rights transfers; and creation of a joint tenancy when adding one or more new joint tenants.<sup>36</sup> Some transactions are exempt from the larger (and newer) state transfer tax but not the smaller (older) county tax. Examples: conveyances to a child, stepchild or adopted child, or to a grandchild, step-grandchildren or adopted grandchild; transfers made pursuant to a bona fide sales agreement (such as land contract) executed before April 1, 1994; transfers between persons sufficiently related to constitute a “single employer” under Section 414(b) or (c) of the U.S. Internal Revenue Code; homestead transfers where the state equalized value is no greater than on the date the seller purchased the property; transfers pursuant to a mortgage foreclosure including a deed in lien of foreclosure; and transfers between two tax exempt religious societies.<sup>37</sup>

If a transaction involving new construction is structured properly, and the land is sold separately from the new house, then transfer taxes may apply only to the value of the land unimproved with a completed residence.<sup>38</sup> Finally, some people have taken the position that purchasing 100% ownership of an entity whose sole asset is a piece of real estate, effectively transfers title to the real estate without a deed and without incurring state or county transfer taxes.

## **Sale or Exchange?**

Two final Internal Revenue Code provisions are worth noting:

Section 121. If a seller owns and uses property as their principal residence for at least two of the five years before the closing, then they can exclude up to \$250,000 of gain from Federal and State income taxes.<sup>39</sup> Married couples filing jointly can exclude up to \$500,000 of gain.<sup>40</sup>

Section 1031. If the home does not qualify as the seller's principal residence, and the seller may not exclude the gain under Section 121, perhaps the seller can defer recognizing the gain under Section 1031. Section 1031 permits a taxpayer to defer recognition of gain through an "exchange" of property they wish to sell, for new like kind property they wish to acquire. Instead of paying income tax on any gain from the sale, the taxpayer uses the money to acquire another property, and reduces their basis in the acquired property by the amount of the deferred gain. Think of it as an interest free loan from Uncle Sam. The taxpayer must hold both properties for productive use in a trade or business, or for investment.<sup>41</sup> Rental property or vacant land normally qualifies as property held for investment, but a personal residence does not.<sup>42</sup> So-called vacation homes, second homes and mixed use properties, if truly "held for investment purposes," can offer opportunities for tax savings under the right circumstances.<sup>43</sup>

## **Final Thought**

With proper diligence, planning and a little luck, you can be a hero to your client when handling their next residential transaction.

***Biography of Gregg A. Nathanson, Esq.***

Gregg A. Nathanson, a shareholder at Couzens Lansky in Farmington Hills, Michigan, served as Editor of Michigan Residential Real Estate Transactions (ICLE 2000). He is former chair of the Michigan State Bar Residential Transactions committee and a member of the Real Property Law Section's Governing Council. He specializes in real estate, environmental, corporate and business law. Mr. Nathanson, a licensed real estate broker, may be reached at [gregg.nathanson@couzens.com](mailto:gregg.nathanson@couzens.com) or (248) 489-8600.

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<sup>1</sup> Bible, Revised Standard, Ecclesiastes, Chapter 1, Verse 9.

<sup>2</sup> Michigan's Seller Disclosure Act requires the seller of an existing residential dwelling to complete and deliver a statutory Seller's Disclosure Statement before a binding purchase agreement is executed. MCL 565.951 *et. seq.*

<sup>3</sup> www.ashi.org, "The Standards of Practice and Code of Ethics of The American Society of Home Inspectors" October 15, 2006

<sup>4</sup> Michigan's Occupational Code provides that an action shall not be brought against a real estate agent for failure to disclose to a purchaser that the real property was or is suspected to have been the site of a homicide, suicide, or other occurrence prohibited by law that has no material effect on the condition of the real estate. MCL 339.2518(b).

<sup>5</sup> Public Acts 497 and 572 of 2006, effective January 3, 2007, MCL 570.1104 *et. seq.*

<sup>6</sup> MCL 570.1110(6).

<sup>7</sup> MCL 570.1110(4).

<sup>8</sup> MCL 570.1115(7).

<sup>9</sup> MCL 570.1110(4) and 1115(9).

<sup>10</sup> 26 U.S.C. § 1445.

<sup>11</sup> 26 U.S.C. § 1445(a).

<sup>12</sup> 26 U.S.C. § 1445(b)(5).

<sup>13</sup> 26 U.S.C. § 1445(b)(2)

<sup>14</sup> 26 U.S.C. § 1445

<sup>15</sup> CNN Money.com, "Unemployment state by state," Your job 2007

<sup>16</sup> The Detroit Free Press, "Selling Short," May 27, 2007; 26 U.S.C. § 61(a)(12), and § 108.

<sup>17</sup> 26 U.S.C. § 108(a). Caution is advised with § 108, as there are numerous limitations and restrictions set forth therein.

<sup>18</sup> Federal Trade Commission Facts for Consumers, "Reverse Mortgages: Get the Facts Before Cashing In On Your Home's Equity" June 2005, [www.ftc.gov](http://www.ftc.gov); Home & Communities, "Top Ten Things to Know if You're Interested in a Reverse Mortgage," [www.hud.gov](http://www.hud.gov); and AARP, "Reverse Mortgages," [www.aarp.org/money/revmort/](http://www.aarp.org/money/revmort/)

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> Organized Crime Digest (Dec 15 2005).

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- <sup>23</sup> Howard Lax, “Recognizing Mortgage Fraud“ Michigan State Bar Journal, November 2007
- <sup>24</sup> MCL 211.27a(6)(a).
- <sup>25</sup> MCL 211.27a(10).
- <sup>26</sup> MCL 211.27a(7)(a); and (b).
- <sup>27</sup> MCL 211.27a(7)(c), (d), (f), (h), and (j)
- <sup>28</sup> MCL 211.27a(6)(h).
- <sup>29</sup> MCL 211.7cc(1) and (2).
- <sup>30</sup> MCL 211.7cc(5).
- <sup>31</sup> Michigan Department of Treasury “Guidelines for the Michigan Homeowner’s Principal Residence Exemption Program,” Chapter 3, Questions 3 and 7. (Rev. Nov. 2006) (“Homestead Guidelines”)
- <sup>32</sup> MCL 211.7cc(3); Homestead Guidelines, Chapter 4, Question 10.
- <sup>33</sup> MCL 207.501 *et seq.*
- <sup>34</sup> MCL 207.521 *et seq.*
- <sup>35</sup> MCL 207.505(a); 207.526(a).
- <sup>36</sup> MCL 207.505(c), (h), (i), (j), (k) (l), (m), (n), and (o) and MCL 207.526(e), (h), (i), (l), (m), (n), (o), (p), and (q).
- <sup>37</sup> MCL 207.526(j), (k), (r), (s), (t), (u), and (v)
- <sup>38</sup> *Lake Forest Partners 2, Inc. v. Dept of Treasury* (Mich Ct. App June 6, 2006).
- <sup>39</sup> 26 U.S.C. § 121(a) and (b)(1).
- <sup>40</sup> 26 U.S.C. § 121(b)(2)(a).
- <sup>41</sup> 26 U.S.C. § 1031(a)(1).
- <sup>42</sup> *Id.*
- <sup>43</sup> Barry E. Moore v. Commissioner, Tax Court Memo 2007-134, (May 30, 2007); Luberto, Michael A., “Tax Deferred Exchanges of Second Homes and Mixed Use Properties,” 31 Mich Real Prop Rev 34 (2004).