

FAST FACTS

When it comes to due diligence, you can never over-inspect. Turn over as many rocks as possible and see what crawls out from under them.

The title insurance industry offers a number of new products that provide homeowners with important consumer-oriented coverages and protections.

Related party transactions, if properly structured, can prevent your clients from paying unnecessary real property taxes.



What's New in Residential Transactions?

By Gregg A. Nathanson

When wise King Solomon said, “There’s nothing new under the sun,”¹ 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.

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 different. 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;² (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 (discussed below); (e) the right to terminate the agreement for any reason during the inspection period; (f) limiting the buyer's liability to loss of the deposit if the buyer defaults; and (g) 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. Do not retain the listing agent's second cousin. 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 rights for homes on or near a lake; lead paint for houses built before 1978; and asbestos, radon, black mold, and other environmental concerns. Turn over as many rocks as possible and see what crawls out from under them.

What About Non-Physical Due Diligence?

Make sure your client considers "non-physical" due diligence. Speak with officers of the homeowners' association, neighbors, and city or township officials, and review pertinent public and private documents to ferret out problems. Perhaps the property suffers 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.³

Get a Survey

Advise that your client obtain a survey. Many mortgage lenders require a basic "mortgage report" survey, which is not certified to your client. Mortgage surveys fail to show property lines, easements, or encroachments with any certainty. 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. However, 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 that your client obtain a better quality survey before deciding whether to close.

What's New in Title Insurance?

While all buyers should obtain title insurance, policies differ. First, suggest that your client obtain (or provide) the new 2006 ALTA (American Land Title Association) 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 an owner's 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, while others require a better survey.

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 that 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, or zoning or subdivision laws. The policy offers enhanced coverage for vehicular and pedestrian access, and continued protection where the buyer transfers title to a living trust after closing. The policy amount increases 10 percent 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 underwriter.

What's New in New Construction?

The Michigan Construction Lien Act was recently amended to better protect homeowners against construction liens, where the homeowners paid their builder/general contractor, but the general contractor failed to pay subcontractors, laborers, or suppliers.⁴ The owner or owner's 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—of receipt of the sworn statement, and provide each potential lien claimant a copy of the sworn statement upon request.⁵ To facilitate this, sworn statements now must include the address and telephone number of each person listed.⁶

In addition, an owner 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.⁷ To make life easier (and harder), these new requirements appear directly on the new forms of sworn statement and construction lien waivers.⁸ The goal is to facilitate communication and verification of contractor, lien waiver, and payment

information, and thereby reduce nonpayment situations, construction liens, and costly litigation.

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.⁹ 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 percent of the purchase price, unless an exemption applies.¹⁰ One common exemption is when the buyer purchases the property for use as his or her personal residence and the purchase price does not exceed \$300,000.¹¹ 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.”¹²

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 the highest in the nation,¹³ and real-estate 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, and dealing with all the headaches of listing the property for sale, finding a new buyer, and maintaining the property in the interim. 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 an independent fair market value appraisal. The disadvantages to a homeowner include loss of any possible equity in the home, reporting of late payments, and potential income-tax liability for discharge of indebtedness equal to the difference between the total amount owed and the payment accepted by the lender.¹⁴

Fraud, Anyone?

The FBI considers mortgage fraud the “fastest growing white collar crime.”¹⁵ Fraud takes many forms and is limited only by the

creativity and ingenuity of perpetrators. If a deal smells fishy, look for “red flags.” 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 the many possible warning signs of fraud. 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.”¹⁶ 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.¹⁷

Some transfers, like transfers between spouses or to a revocable living trust, are *not* uncapping statutory transfers of ownership. On the other hand, transfer of a majority ownership interest of a private corporation or limited liability company that owns real estate, is an uncapping transfer of ownership, even though there is no deed transferring real property.¹⁸ 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, was previously discussed. The (millage) rate component varies, depending on whether 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 enjoy an exemption from a portion of their local school operating taxes,¹⁹ and are taxed at the lower “homestead” rate. When homeowners sell their home or cease to occupy property as their primary residence, they have a duty to file an affidavit rescinding their principal residence exemption.²⁰ A buyer then must file his or her own (new) Homeowner’s Principal Residence Exemption Affidavit.

What about related party transactions? If parents deed their home to their children, and retain a life lease or life estate, the parents may still continue to claim a homestead exemption for the property even though they do not legally own it.²¹ Under certain circumstances, a husband and wife can claim two separate homestead exemptions for two different residences.²² As

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with uncapping, consider opportunities for lawfully preserving or claiming a homestead exemption when handling estate planning, related party, or oddball transactions.

What About Real Property Transfer Taxes?

Michigan has two real property transfer taxes: the county tax is \$.55 per \$500 of value,²³ and the state tax is \$3.75 per \$500 of value.²⁴ Both taxes combined equal .86 percent 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? Some transactions are exempt from the larger state transfer tax but not the smaller county tax, e.g., conveyances to a child, stepchild, or adopted child, or to a grandchild, step-grandchildren, or adopted grandchild. With new construction, if the land is sold separately from the house, then transfer taxes may apply only to the value of the land, and not to the completed residence.²⁵ Some people have taken the position that purchasing 100 percent 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. Other exemptions are found in MCL 207.505 and MCL 207.526.

Sale or Exchange?

Two final Internal Revenue Code provisions are worth noting. Under Section 121, if a seller owns and uses property as his or her principal residence for at least two of the five years before the closing, then the seller can exclude up to \$250,000 of gain from federal and state income taxes.²⁶ Married couples filing jointly can exclude up to \$500,000 of gain.²⁷

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 taxpayers to defer recognition of gain through an "exchange" of property they wish to sell, for new property they wish to acquire. Instead of paying Uncle Sam income tax on any gain from the sale, the taxpayer uses those tax-deferred dollars to acquire another property. The taxpayer must hold both properties for productive use in a trade or business, or for investment.²⁸ Rental property or vacant land normally qualifies as property held for investment, while a personal residence does not.²⁹ 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.³⁰

Final Thought

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

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FOOTNOTES

- 2 Ecclesiastes 1:9 (Revised Standard).
- MCL 565.951 *et seq.* (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 339.2518(b) (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 570.1104 *et seq.*
- MCL 570.1110(6).
- MCL 570.1110(4).
- MCL 570.1115(7).
- MCL 570.1110(4), MCL 570.1115(9).
- 26 USC 1445.
- 26 USC 1445(a).
- 26 USC 1445(b)(5).
- 26 USC 1445(b)(2).
- Unemployment state by state*, CNN Money.com, September 25, 2007, available at <http://money.cnn.com/pf/features/lists/state_unemployment/> (accessed October 14, 2007) (listing the unemployment rates state by state for August 2007).
- Selling Short*, The Detroit Free Press, May 27, 2007; 26 USC 61(a)(12), 26 USC 108. U.S. Congress is considering Mortgage Forgiveness Debt Relief Act of 2007, which would amend Internal Revenue Code to exclude discharges of indebtedness secured by principal residences from gross income. H.R. Bill 3648.
- Mortgage Fraud is Top White Collar Crime*, Organized Crime Digest, December 15, 2005, available at <http://findarticles.com/p/articles/mi_qa4441/is_200512/ai_n16065739> (accessed October 14, 2007).
- MCL 211.27a(6)(a).
- MCL 211.27a(10).
- Transfer of Ownership and Taxable Value Uncapping Guidelines*, Michigan Department of Treasury State Tax Commission/Property Tax Division, p 2, March 31, 2001, available at <http://www.michigan.gov/documents/Transfer_of_Ownership_Q&A_128474_7.pdf> (accessed October 14, 2007).
- MCL 211.7cc(1), MCL 211.7cc(2).
- MCL 211.7cc(5).
- Guidelines for the Michigan Homeowner's Principal Residence Exemption Program*, Michigan Department of Treasury, p 3, November 2006, available at <http://www.michigan.gov/documents/2856_11014_7.pdf> (accessed October 14, 2007).
- Id.* at 5; MCL 211.7cc(3).
- MCL 207.501 *et seq.*
- MCL 207.521 *et seq.*
- Lake Forest Partners 2, Inc v Dept of Treasury*, 271 Mich App 244; 720 NW2d 770 (2006).
- 26 USC 121(a), 26 USC 121(b)(1).
- 26 USC 121(b)(2)(a).
- 26 USC 1031(a)(1).
- Id.*
- Moore v Commissioner*, Tax Court Memo 2007-134, May 30, 2007, available at <<http://www.ustaxcourt.gov/InOpHistoric/Moo8re.TCM.VPD.pdf>> (accessed October 14, 2007); Luberto, *Tax deferred exchanges of second homes and mixed use properties*, 31 Mich Real Prop Rev 35 (Spring 2004), available at <<http://www.michbar.org/realproperty/MRPR/spring2004.pdf>> (accessed October 14, 2007).