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John P. Tamboer PLC

Estate Planning News You Can Use Today

Real Estate Transfers: "To Deed or Not to Deed — That is the Question"

Special points of interest:

- Two forms of deeds are used to transfer most property
- Multiple owners of property face challenges for estate planning
- Taxes are a key consideration for any property transfer
- Don't make a simple mistake that could cost you thousands

Introduction

The title of this article is as close as I have ever come to quoting Shakespeare. But it seemed appropriate because navigating the complex world of real estate transactions can feel a lot like reading *Hamlet* – it's all in English, but you're not quite sure what it says. These complexities are heightened in the context of estate planning, where real estate transfers are frequently done without actually selling property to another person.

In this article we will review the kinds of deeds that may be used to transfer real estate, various forms of ownership, tax implications, and other issues that must be considered in every real estate transfer – hopefully in English you can understand. And, we'll mix in a little Shakespeare along the way just to keep things interesting.

"To Deed or Not To Deed – That Is the Question"

Of course, Shakespeare didn't use these words, but maybe he should have. Conveying real estate is sometimes a complex matter, that can have long-term consequences. We have encountered numerous problems, especially in the context of probate administration, where property was incorrectly conveyed, or not conveyed as the parties intended.

In Michigan, the most common forms of deeds used to convey real property are a *quit claim* deed or a *warranty* deed. A deed must meet certain statutory requirements to be effective. It must also be in proper form in order to be recorded at the register of deeds office. Recording a deed is crucial to its validity, because only recorded deeds are given legal effect. The type of deed used in a real estate transfer may have significant impact on the title to property – more on that subject later.

The first type of deed in common use is a *quit claim* deed. By using a quit claim deed a transferor will convey only so much of the title to property that he or she owns - even if the title is subject to disputes, mortgages, easements, or liens. Quite literally, a quit claim deed is used to *quit* a claim – i.e. the transferor gives up whatever title he owns even if it is defective. A quit claim deed will always contain the words "quit claim", as in the form: "Tom quit claims to Harry". The most important thing to remember about a quit claim deed is that it provides no assurance to the transferee that the transferor has clear title to the property.

The second form of deed is referred to as a *warranty* deed. Again, the meaning here is literal: a warranty deed is a *guarantee* by the transferor that he or she has clear title to the property

and is conveying it to the transferee. The purpose of a warranty deed is to provide additional protection to the recipient of property by having the transferor guarantee that they have good title to the property.

The transferor is then obligated by law to defend the title and to compensate the transferee if there are problems with the title that were present when the property was conveyed. A warranty deed will contain the words "conveys and warrants", as in the form "Tom conveys and warrants to Harry".

Another type of deed that is becoming increasingly common is referred to as a "power of appointment deed" or *ladybird* deed. A ladybird deed is a form of warranty deed in which owners of property grant life estates to themselves and then name a person to receive the property when they die. Ladybird deeds are ideal for owners of property who want to avoid probate, maintain control of property while they are alive, and only transfer it to designated heirs upon death.

Multiple Owners: "Ay, There's the Rub…"

Once the type of deed is chosen, the next issue is to decide how the property will be owned. There are numerous property interests that a person can own, including easements, life estates, mineral rights, timber rights, and so on. However, most people intend to convey an entire parcel, and all of the ownership rights. In that case, it is important to describe the *form* of ownership in the deed.

When a parcel of property is being transferred to only one person, it is sufficient to identify that person, and if the person is a male, to describe his marital status in the deed. However, when two or more persons are owners, the form of ownership is much more important. Multiple owners can be described as "tenants in common", "joint tenants", "joint tenants with rights of survivorship", or "tenants by the entireties".

The term *tenants in common* refers to a form of ownership in which two or more persons own a divisible interest in the property. For example, if property is conveyed to Tom, Sue, and Jane as tenants in common, then each of them would own a divisible one-third interest in the property. Tom, Sue, and Jane may convey their share of the property to another person, and that person would own a one-third share with the remaining owners. If Tom, Sue or Jane dies, their share would pass to their respective heirs.

Two or more people can also own property as *joint tenants*. There are two forms of joint tenancy: with survivorship rights and without survivorship rights. *Joint tenancy* (without survivorship rights) describes a form of ownership in which each of the owners own an indivisible right to the property – that is, they each share title to the entire parcel. If one of the owners dies, then the surviving owners will own the entire parcel, and the heirs of the deceased owner have no right to inherit the property. However, if one of the joint tenants conveys his or her ownership to another person, then the joint tenancy is severed and the new owner will become a tenant in common with the remaining owners.

When two persons own property as *joint tenants with rights of survivorship*, they actually own joint life estates with a remainder interest to the survivor. As a result, none of the joint owners can completely convey their ownership to another person. For example, assume that Tom and Jane owned property as joint tenants with rights of survivorship. Tom then sold his ownership to Gary, and Tom died with Jane still surviving. In that case, Gary would own nothing because Jane never gave up her survivorship interest. The key point is that joint tenancy coupled with rights of survivorship is usually permanent unless all of the owners consent to change the form or ownership.

Finally, Michigan law recognizes a form of tenancy referred to as *tenancy by the entireties*. This form of ownership is limited to married spouses only. In fact, a conveyance to a husband and wife as "joint owners" automatically creates a tenancy by the entireties. Tenancy by the entireties is important to married couples because the title of either the husband or the wife cannot be attached by their respective creditors. For example, if a married spouse in-

curs a debt that cannot be paid, then the property that he or she owns as a tenant by the entireties cannot be seized to pay the debt. In addition, as in the case of joint tenancy with rights of survivorship, a tenancy by the entireties cannot be severed by only one of the owners.

The important distinction between property owned as *tenants by the entireties* and *joint tenants* is that property owned by joint tenants is subject to seizure by the creditors of any of the joint owners (with or without rights of survivorship). This is one reason that joint ownership is a very risky proposition. On the other hand, for owners of property as *tenants in common*, creditors can only reach that portion of the property that is individually owned by the debtor.

Now that we have covered the types of deeds that may be used to convey real property, and the methods of ownership that may be employed, we can turn our attention to other issues that affect transfers of property. Naturally, taxes are always a consideration.

Taxes: "Take Arms Against a Sea of Troubles…"

Of course, in the most famous scene of *Hamlet,* Shakespeare wasn't concerned with taxes, but rather the pros and cons of taking one's own life. Property taxes aren't as troubling as suicide, but then again, most of us aren't concerned with that. Taxes, on the other hand, are a sure thing. A transfer of property in Michigan will involve property tax, transfer tax, and capital gains tax.

Property Tax

As anyone who owns property is aware, property taxes are assessed on the taxable value of real property in the state of Michigan. The taxable value and the fair market value of property are usually different because of the limitations imposed by the General Property Tax Act (Act 206). Pursuant to Act 206, taxes on residential property cannot rise more than the annual rate of inflation, or 5% per year, whichever is less. As a result, property that is owned for a long period of time by a single owner is very likely to be taxed at a rate that is far below its fair market value. When the increase in taxable value is limited by Act 206, it is referred to as "capped" for purposes of assessing taxes.

Whenever that property is sold or transferred to another party, then its taxable value will be "uncapped" – meaning that its taxable value will increase to its true cash value. The new owner will usually pay higher taxes based on the new taxable value. There are numerous circumstances in which taxable value can be "uncapped" by an unwitting transferor even if the property is not sold. Whenever property is transferred, its taxable value will be uncapped unless a specific statutory exception applies. Therefore, transferring real property can have a significant impact on its taxable value.

Transfer Tax

The next type of tax that is implicated in most real estate transactions is referred to as "transfer tax." As the name suggests, transfer tax is paid when property is transferred to another person. There are two forms of transfer tax – state and county. The state transfer tax is $7.50 per thousand, while the

county transfer tax is $1.10 per thousand, for a total of $8.60 per thousand dollars of value. So, if a home is sold for $300,000.00, then the transfer tax would be $2,580.00 (300 x $8.60). In most cases, the seller is liable to pay transfer tax when the property is sold.

There are numerous exceptions to the law requiring the payment of transfer tax, and most of them will be utilized where property is being transferred in a non-sale setting. For example, a spouse does not have to pay transfer tax upon the transfer of real property to another spouse merely for the purpose of creating or terminating a joint tenancy. Transfer tax also does not have to be paid on any transfer where the amount of money being exchanged is less than $100.00. Nevertheless, transfer tax must be considered in every real estate transfer, and the statutory exception must be stated on the face of the deed for it to be applied.

Capital Gains Tax

Finally, capital gains tax often comes into play when property is sold or transferred. Capital gains

taxes are based upon the increase in value that a person has experienced during their ownership. The capital gains tax rate is generally 15% for real estate. The tax is not applied to the full purchase price, but only to the increase in value that a taxpayer has realized.

For tax purposes, the price that a person pays for a parcel of property is referred to its *basis* (basis can be adjusted, but we will assume that it remains constant). Capital gains tax is assessed on the difference between the sale price and the basis. Basis is an important concept in estate planning because it can increase or decrease depending upon how property is transferred.

For example, assume that Tom bought a parcel of commercial land for $50,000. If Tom sold the land for $75,000, then he would pay capital gains tax on the difference between his basis of $50,000 and the sale price of $75,000. However, if Tom died when the property was worth $75,000, and the property was transferred to his heirs, then their basis would increase to the value of the property on the date that Tom died. If Tom's heirs sold the property for $75,000, then they would not pay any capital gains tax because their basis and the sale price are the same. On the other hand, if Tom *gifted* the same property to his children while he was alive, then they would take *his* basis. This is referred to as "carryover" basis. If Tom's children sold the property, then they would pay capital gains taxes in the same manner as though they were the original purchasers.

Capital gains taxes generally do not apply to the sale of personal residences due to the *principal residence exclusion*. In general, the taxpayer can exclude from gross income the gain realized on the sale or exchange of a principal residence up to a ceiling of $250,000.00 ($500,000.00 for married taxpayers filing jointly). This exclusion applies if, during the five year period ending on the day of the sale or exchange of the residence the taxpayer owned and used the property as the taxpayer's principle residence for any period aggregating two years or more. However, the exclusion generally applies to one sale or exchange in a two year period.

Title Insurance: "The Undiscovered Country from Whose Bourn No Traveler Returns…"

Title insurance was unknown in Shakespeare's time, but our whole system of real estate conveyance depends on it. The ability of anyone to sell real estate transfers is built around the concept of "marketability", and title insurance is what makes property marketable.

The term "marketability" refers to the ability of a seller to convey clear title to a piece of property. After all, if buyers do not have an ironclad guarantee of clear title, why would they buy a piece of property? Title insurance companies provide such a guarantee to buyers, and as such, they are the gatekeepers for our mortgage and real estate system.

Title insurance companies are in the business of researching titles, correcting title problems, and ensuring the marketability of property. Therefore, it is imperative that property purchased at market value be insured by a reputable title company. If a problem later arises with a title to a parcel of insured property then the title company will assist the owner to rectify the title problem or to compensate them for loss of value as a result of the imperfection. Title insurance is generally purchased by the seller of the property and provided to the buyer to guarantee that he or she has marketable title.

[Important Note: Title insurance only insures the original policy holder for so long as they own the property. Title insurance coverage is generally terminated when the property is transferred – especially when using a quit claim deed.]

Probate: "But that the Dread of Something After Death…"

If you are confused about the implications of transferring real estate, then you are not alone. We are often confronted with mistakes made by unsuspecting owners of property. Let's go through one ex-

ample that will serve to illustrate some pitfalls of transferring real estate by someone who did not consider all of the implications.

Alex is 72 years old. He owns a home where he has lived for more than 30 years. Alex's wife died last year so he is aware of the need for estate planning. He has been doing some reading on the subject, and have even attended a couple of seminars. Based on his research, Alex is convinced that probate is an expensive and time consuming process, and that he must avoid it if possible. Alex heard from one of his neighbors that transferring his property to his children by deed will avoid probate. The neighbor said it's as easy as buying a form, and filing it with the register of deeds. Alex thought this seemed like the perfect solution – cheap and easy – no lawyers or messy estate planning. He immediately bought a deed form from the office supply store, filled it out to transfer ownership to his children, and filed it with the register of deeds. Everything seemed fine, until —

1. Six months later Alex got his tax bill from the local assessor's office notifying him that the taxable value of his property tripled to its current cash value. The property taxes payable by Alex also tripled from the previous year, and his homestead exemption was revoked since he no longer owned the residence. Appeals to the assessor's office by Alex's lawyer were unsuccessful since the property was "transferred" within the meaning of the General Property Tax Act.

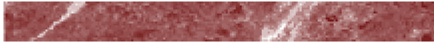
2. Two years later, Alex needed nursing home care. Because he transferred his home to his children for less than fair market value, he was denied Medicaid assistance by the State of Michigan. The penalty period caused by the transfer will not expire for another 2 years. Alex will soon exhaust his savings to pay for the nursing home, so one of his children moved into the residence just to keep it up.

3. After about a year, the children were forced to sell the house to pay for Alex's nursing care. However, because they received the home as a gift, they were required to pay capital gains tax on the difference between what Alex paid for the home and its sale price – a difference of $90,000. The total tax bill was $13,500 (probate would have cost a fraction of that amount).

4. The title insurance coverage on the home was terminated when it was deeded to Alex's children. If title problems had arisen when the property was sold, no coverage would have been in place.

In this example (which is based upon actual events), Alex lost tens of thousands of dollars trying to save a few hundred dollars on probate. Simple estate planning would have saved property taxes, nursing home costs, capital gains tax, and attorney fees – and even avoided probate. Alex's situation is very common, and illustrates only one potential problem with transferring real estate to avoid probate, or to "plan" an estate.

We hope this article will help you to consider the consequences of transferring property the next time that you are about to sign a deed. And, just in case you are interested where the title quotes came from, here is a link to *Hamlet's* entire soliloquy from Hamlet, Prince of Denmark. JPT



4701 Plainfield Ave. NE
Grand Rapids, Michigan 49525

Phone: 866.230.4200
E-mail: info@michiganestateplan.com
Web: www.michiganestateplan.com

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