

## Legal Update

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### Hot Topic: Supreme Court Tackles the “Uncapping” Issue

By Robert W. Parker, Attorney

The Michigan Supreme Court recently issued an opinion in a case that significantly impacts property taxes and estate planning. The following is an analysis of how the *Klooster v. City of Charlevoix* decision impacts property tax bills in joint tenant transfers.

#### Background

All property tax bills contain three values: Taxable Value, Assessed Value and State Equalized Value. Property taxes are calculated by multiplying the millage rate in a community by a property’s Taxable Value. The Assessed Value should represent 50% of the property’s true cash value, but it is not used to determine taxes owed.

In 1994, the citizens of Michigan adopted Proposal A that became effective beginning in 1995. Among other things, Proposal A *capped* increases in a property’s taxable value to either the rate of inflation or 5%, whichever was less. It also created the notion of Taxable Value. Prior to 1994, taxes were assessed against a property’s Assessed Value, increases of which were unlimited.

The Act also provided, however, that when there was a transfer of a parcel, the parcel’s Taxable Value in the year following the year of transfer would be its State Equalized Value (which most often is the Assessed Value). This is what is described as the *uncapping* of a parcel’s taxable

value and often times results in a significant increase in a parcel’s annual property tax bill.

Because of the restrictions on increases in Taxable Value imposed by Proposal A, the Taxable Value for many parcels after 1994 began to significantly lag behind their Assessed Value, where increases were not restricted. By 2010, statewide, the “gap” between Taxable Value and Assessed Value had grown to \$46 billion. In order to avoid significant increases in their property taxes when a transfer occurred, taxpayers and their lawyers examined each transfer to determine if it might qualify as one of the 15 transfers exempt under statute.

#### Joint Tenancy Exemption: *Klooster v. City of Charlevoix*

One transfer that the Legislature identified as exempt was a transfer creating or terminating a joint tenancy.

The transfer had to be between two or more persons and at least one of the persons needed to be an *original owner* of the property before the tenancy was initially created.

In 1959, James and Dona Klooster acquired their home in the City of Charlevoix. In August of 2004, Dona quitclaimed her interest to her husband James, leaving him as the sole owner. On that same day James quitclaimed the property to himself and his son, Nathan Klooster, as joint tenants with full rights of survivorship. On January 11, 2005, James died leaving Nathan as

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the sole owner. On September 10, 2005 Nathan quitclaimed the property to himself and his brother, Charles Klooster, as joint tenants with full rights of survivorship.

The assessor uncapped the property's taxable value upon James' death claiming that his death was a transfer. Appeals ensued and the Kloosters ultimately found themselves before the Michigan Supreme Court which issued its decision of March 10, 2011 in *Klooster v. City of Charlevoix*. On March 21, the Executive Director of the Michigan State Tax Commission issued her guidance document to the state's assessors and equalization directors instructing them as to how to implement the Court's decision in *Klooster*.

The Michigan Supreme Court provided the Kloosters with a partial victory. It identified a total of five transfers that the Kloosters had been part of. The first was when the Kloosters acquired the property in 1959. The second was when Dona conveyed to James. The third was when James conveyed to Nathan and himself. The fourth was when James died, and the final transfer was when Nathan conveyed to his brother, Charles. The Court provided that of those five transfers, only one constituted a transfer resulting in an uncapping of the property's taxable value and that was the last one, from James to his brother. While it rejected the Kloosters' argument that James' death was not a transfer, it concluded it was nevertheless an exempt transfer. That's the good news. The bad news is that the Court specifically held that the "creation" of a joint tenancy will not always be an exempt transfer.

### **Moving Forward: The Decision's Impact**

There are a number of significant take-always from the *Klooster* decision:

1. If handled properly, the Supreme Court has provided taxpayers with a least a one-generation reprieve from uncapping. We now know that if mom and dad put the property into their names with their son or

daughter, that upon mom and dad's deaths, there will be no uncapping.

2. The more the merrier, meaning that it may make the most sense to put all of the children on the deed. What triggered the Klooster's uncapping was the conveyance by Nathan to his brother. If the elder Klooster had conveyed to Nathan and Charles initially, the property's Taxable Value would still be capped.
3. Real estate and estate planning lawyers will take a hard look at joint tenancy as an estate planning tool and, within the joint tenancy, the parties' common law rights and responsibilities. To the extent property owners do not like those rights or responsibilities or they don't mesh with their needs, joint tenancy agreements must be created to re-define those rights.

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4. There is more to come. Given the statute's ambiguity, which even the Supreme Court acknowledged was "not the simplest provision to understand at first reading," interpretations of the joint tenancy exemption have varied amongst assessors and equalization directors throughout the state. With the Court's ruling, we now have a definitive, single interpretation. The State Tax Commission has provided that the decision may necessitate examination by assessors and equalization directors dating back to the beginning of Proposal A in 1995. In other words, transfers that had previously been determined to be non-exempt may now be deemed to be exempt or, worse, transfers which were deemed to have been exempt may now be deemed to be non-exempt, resulting in back taxes owed. How far back assessors may go and if they can go back at all may depend largely upon whether a property transfer affidavit was filed at the time of the non-exempt transfer.

5. The chain of title becomes very important as the term “original owner” was defined by the Court to mean a person who was the owner at the time of the last transfer which resulted in an uncapping. For the Klooster family that was 1959, when they originally acquired the property.
6. There are some very intriguing planning opportunities using joint ownership between unrelated parties which may result in exempt transfers.
7. And finally, the gap between Taxable Value and Assessed Value will continue to swell as years pass. Any conveyance of real estate, whether part of a sale or purchase of real estate, estate planning, marital settlement,

adjustment of boundary line, however simple on its face, could result in significantly adverse property tax consequences if not handled properly. A lawyer with an understanding of real estate and Proposal A should always be involved.

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**The decision in *Klooster v. City of Charlevoix*, also lead to a positive result for Smith Haughey’s client in, *Taylor v. City of Traverse City*. Because it involved the same “uncapping” issue, the *Taylor* case was a companion case to *Klooster* in the Michigan Supreme Court. The Taylors were represented by attorneys Robert Parker and Jon Vander Ploeg.**

## Gain on the Sale of a Primary Residence

By George F. Bearup, Attorney

**I**nternal Revenue Code (IRC) Section 121 provides a \$250,000 capital gain exclusion on the sale of a principal residence if it was occupied for two out of the last five years. The owner must have lived in the principal residence at least two of the five years immediately preceding the sale.

Why this is significant is that that same rule applies even after the death of the property owner. Accordingly, if a decedent’s principal residence is sold within three years after the decedent’s death, it will nonetheless qualify for the IRC Section 121 exclusion even if an heir (or the decedent’s estate

or a revocable Trust) never used the residence as a principal residence.

This may not make much difference with a “step-up” of the income tax basis of the residence to its fair market value as of the date of the owner’s death, but the rule could absorb any post-death appreciation of the residence prior to the time that the heir or the decedent’s Trust end up selling the real property. Otherwise, a conventional Trust is not entitled to use the IRC Section 121 election.

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## Tenancy-by-the-Entireties: Vulnerable to Super-Creditors

By George F. Bearup, Attorney

**L**ike many states, Michigan provides by statute that some assets are exempt from judgment creditors. Those state exemptions protect a homestead, the cash surrender value of life

insurance, annuities, and individual retirement accounts (IRAs). Another prominent statutory exemption in Michigan relates to property that a husband and wife own as tenants-by-the-entirety:

a judgment creditor of one spouse cannot access the entireties-owned asset to satisfy its judgment. While this is the general rule, not all judgment creditors are alike.

A couple of statutes give the federal government the equivalent of a “super-creditor” status. If a specific federal enforcement statute exists, such as the lien statute as given to the Internal Revenue Service (IRS), or a “disgorgement” statute held by the Securities and Exchange Commission (SEC), the federal government can use its own rules to preempt state exemption statutes and proceed to collect its judgments. If a federal agency does not benefit from a specific collection statute, then the agency must look to state law to collect a judgment; in this situation, the federal agency will be subject to the state’s judgment exemption statutes.

Nine years ago, the U.S. Supreme Court held that while Michigan’s tenants-by-the-entireties exemption statute provided that a spouse’s creditor could not attach the tenancy-by-the-entirety rights held by the debtor-spouse, federal law – not Michigan’s law – determined whether the tenancy-by-the-entirety rights constitute *property* for federal tax lien purposes. The Court allowed the IRS to attach the tenancy-by-the-entirety property regardless of Michigan’s exemption statute that generally prevents a creditor’s attachment of entireties-owned property. A year later, the Sixth Circuit Court of Appeals held that not only could the IRS lien attach to the tenancy-by-the-entirety property, but the IRS could also force the sale of that Michigan entireties-owned property.

While the IRS, and presumably the SEC, are given enhanced rights that supersede Michigan’s exemption statutes, there are outer-limits to those federal rights. For example, a federal bankruptcy trustee is not considered a “super-creditor” with regard to Michigan tenancy-by-the-entireties property. A federal bankruptcy trustee represents

the interests of creditors; since most are creditors under state law, the bankruptcy trustee cannot attach or foreclose on entireties-owned property when only one spouse has filed for bankruptcy.

This extraordinary federal agency’s “super-creditor” status was recently ratified. In that case, the debtor and his wife removed millions of dollars of equity from their entireties-owned property and then placed the proceeds in a foreign trust created by the wife just a few months before a \$6 million judgment was entered against the debtor. A federal court held that a Florida entireties exemption statute did not protect the debtor from the SEC’s judgment and it allowed the SEC to reach the wife’s foreign trust’s assets since she orchestrated the fraudulent transfer.

Prior to 1983, the general rule was that state law – not federal law – determined what constituted *property*. That changed when the United States Supreme Court held that state law determines the *nature* of an interest, or the type of *rights* a person holds, but federal law determines whether that interest constitutes a *property interest*. Under federal law, if the interest held by an individual is sufficient to equate to *property*, then federal agencies that have access to a specific federal lien or collection statute can attach the property as well as sell it, regardless of clear state exemption laws to the contrary. This applies to all types of assets, e.g., IRAs; tenancy-by-the-entireties owned assets; pensions; cash surrender values of life insurance, annuities, etc.

While there is some comfort in the knowledge that specific Michigan exemption statutes protect certain assets from judgment creditors, those statutes will not prevent the IRS or the SEC from seizing and selling those protected assets to satisfy their judgments.

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