



KEEPING THE FAMILY COTTAGE: PROPERTY TAX PITFALLS FOR TRANSFERS BETWEEN PARENTS AND CHILDREN

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Transferring the family cottage without careful planning can inadvertently lead to a big jump in property taxes. Waterfront properties have tended to increase in value more rapidly than non-waterfront properties. This is especially true now that Michigan's real estate market is so hot, causing waterfront property values to soar. Factor in unexpected COVID-related deaths, and you have a recipe for unexpectedly having to sell the family cottage due to sky-rocketing property taxes, or at least a monstrous, unforeseen, and potentially crippling property tax bill. Transferring a vacation home to a limited liability company (an "LLC") had been an estate planning tool and also a common way to try to avoid those unexpected property increases, but according to the Michigan Court of Appeals, that may no longer be an option.

Most cottage owners are familiar with Proposal A (adopted by Michigan voters in 1994), which states that the taxable value of a property (the amount on which a property owner pays property taxes) cannot increase from one year to the next by more than the rate of inflation or five percent—whichever is less—until there is a transfer of ownership. When there is a "transfer of ownership" to a new owner, the taxable value of the property is "uncapped" so that it increases to the state equalized value, which is supposed to represent 50 percent of the property's fair market value.

This means that when real estate markets are hot (fair market values are high and increasing quickly) and inflation is low (like it has been for some time now), property taxes increase gradually with inflation from year to year until there is a transfer of the property. Then the taxable value (which may be lower than the assessed or state equalized value) is uncapped and jumps up to reflect the current market value—and the new owner gets a whopper tax bill and will have to continue paying property taxes at that new higher rate. This is true even in some cases when it is transferred between family members—unless certain steps are taken to avoid this uncapping.

An uncapping event can be avoided if the proper procedure is utilized to put members of the immediate family on the deed or the property is transferred to the appropriate trust based upon the advice of an expert estate planning attorney or other qualified professional. However, if the proper process is not utilized, an uncapping event could occur.

Michigan cottage owners have often transferred their vacation homes to limited liability companies while they are alive to allow for a smooth transfer of the property to their children later and to avert an uncapping of property taxes that could cause the children to lose the family cottage. While this used to be considered a solid transfer plan for a family cottage, the Court of Appeals shot that down in *Scott v South Haven*.

In that case, the cottage owner transferred her cottage from herself to an LLC. Ms. Scott was the only member of the LLC. Several years later, she had the LLC transfer the cottage back to herself. The city of South Haven dubbed the transfer from the LLC to Ms. Scott a transfer of ownership that uncapped the taxable value of the property despite Ms. Scott having been the only actual beneficiary of the transfer for both sides of the transaction. Ms. Scott contested the uncapping, but the tax tribunal affirmed it. She then appealed the tribunal's ruling to the Michigan Court of Appeals, but it held that because she owned the cottage for personal use and the LLC did not conduct any business, it did not qualify as a "legal entity". Accordingly, the transfer was subject to uncapping. The Michigan Supreme Court declined to review the Court of Appeals' ruling, so the Court of Appeals decision is final.

While the Court of Appeals' decision is unpublished (meaning it does not formally set a precedent that other courts must follow), it is a strong guideline for the pitfalls of an uncapping event. For further guidance on how to avoid property tax uncapping in the event of a transfer, please contact an experienced estate planning or real estate attorney. *R.*