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**TAX COURT APPROVES IRS
HINDSIGHT ON VALUATION**

In an opinion filed on January 6th of this year, the Tax Court approved the use of a post-death purchase and sale transaction as evidence of value. *Estate of Noble v. Commissioner*, T.C. Memo 2005-2.

Helen M. Noble died on September 2, 1996, while a resident of Gage County, Nebraska. At the time of her death, she held an 11.6% ownership interest in a closely-held corporation. Her stock was sold to the only other shareholder in that corporate entity approximately 14 months after the date of her death for a price which was apparently negotiated in an arms length transaction. In holding generally for the Commissioner of Internal Revenue, the Tax Court rejected the taxpayer's argument that the post-death purchase and sale transaction should be ignored because it was a subsequent event and would not have been considered by a hypothetical willing buyer as of the date of the decedent's death. In rejecting the taxpayer's argument, the Tax Court cited an earlier 8th Circuit Opinion which held that: In determining the value of unlisted

stocks, actual sales made in reasonable amounts at arms length in the normal course of business within a reasonable time before or after the basic date are the best criterion of market value.

In arriving at its conclusion, the Tax Court determined that there were no intervening events which drastically changed the value of the property between the date of death and the subsequent purchase and sale.

Like many things in life, timing is everything. Although the Tax Court did not specifically discuss the matter of timing, the underlying rationale for the Court's holding seems to be that the post-death purchase and sale transaction was simply too close in time to the date of death (within 14 months) and, therefore, became the principal criterion in determining the issue of valuation. If the purchase and sale transaction had been postponed until after the estate tax audit had been completed, there probably would not have been a significant issue raised as to the estate's valuation on the estate tax return. However, by pushing forward with the purchase and sale transaction before the estate tax audit was closed out, the purchase and sale transaction became a significant issue.

The position of the Internal Revenue

Service in using hindsight with respect to valuation issues is certainly not new. Estate Tax Examiners have been utilizing that practical approach for many years. However, with proper planning, the issue could have been avoided and the value originally reported on the estate tax return probably would have been accepted as filed.

Robert J. Murray

INSIDE THIS ISSUE

EMPLOYMENT

Court Reverses Determination
That COBRA Election Notice
Had Been Mailed

ESTATE PLANNING

Tax Court Approves IRS
Hindsight On Valuation

Powers Of Attorney:
What They Are And Why
You Need Them

TAX

One Home Sale,
Two Tax Breaks

Protect Yourself
In Tax Audits

**POWERS OF ATTORNEY:
WHAT THEY ARE AND
WHY YOU NEED THEM**

A good estate plan should include power of attorney documents. In a power of attorney document, the principal (person executing the document) authorizes a third party to make decisions on his or her behalf while he or she is still alive, but is unable to make decisions for himself or herself. The authority of the third party under the power of attorney document ends upon the death of the principal. Consequently, the person appointed in the power of attorney document has no authority with respect to the principal's estate once the principal has died.

Power of attorney documents will make the management of financial and health care matters much easier and less expensive.

A financial power of attorney gives the third party the right to make a broad range of financial decisions for the principal including: making any financial decision the principal could make, writing checks, changing beneficiary designations and making investment decisions. In addition, if the principal desires, the third party can be authorized by an express provision in the document indicating the third party can make gifts on behalf of the principal.

Avoiding the need for a court to appoint a guardian or conservator once the principal is no longer able to make decisions for himself or herself is

the primary advantage of executing a financial power of attorney. Guardianships and conservatorships are matters of public record that render the financial and health care concerns of the ward open to public review. In addition, a court may choose to appoint someone to serve in these capacities whom the principal would never choose. The administration of a guardianship and conservatorship will very likely lead to greater costs in the long run than the execution of powers of attorney while the principal is still able to do so.

Health care powers of attorney allow the third party appointed by the principal to make treatment decisions for the principal, choose physicians, admit the principal to a hospital or care facility and have access to the principal's health care information. In addition, many principals include advance health care directives in their health care powers of attorney in which they dictate their desire that extraordinary measures not be taken to prolong life. If Terri Schiavo would have had a health care power of attorney with a directive relating to extraordinary measures to prolong life, the litigation and more importantly, the family turmoil, could have been avoided.

Every individual should have powers of attorney in place as part of his or her estate plan. In the event an individual is unable to manage his or her affairs, power of attorney documents will make the management of financial and health care matters much easier and less expensive.

Angela M. Pelan

**ONE HOME SALE,
TWO TAX BREAKS**

A recent Revenue Procedure (Rev. Proc. 2005-14) outlined how the sale of a home, which is used partly for business, can qualify for the tax exclusion for home sales under § 121 of the Internal Revenue Code (the "Code") and the tax deferral for like-kind exchanges under § 1031 of the Code.

Under § 121 of the Code, a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least two of the last five years. The amount of the exclusion is limited to \$250,000 (\$500,000 for certain joint returns). However, any gain attributable to depreciable adjustments for periods after May 6, 1997, is not eligible for the exclusion. This exclusion must be applied to the gain realized before applying the § 1031 deferral.

Under § 1031 of the Code, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like-kind. However, unlike the § 121 exclusion, this deferral can apply to a gain attributable to depreciable adjustments after May 6, 1997.

For example, assume taxpayer A buys a house for \$210,000 and uses it as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of \$20,000. In 2006, A exchanges the house for a townhouse with a fair market value of \$460,000 that A intends to rent to tenants. A realizes a gain of \$270,000

on the exchange.

A's exchange of a house satisfies both §§ 121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owned and used the house as A's principal residence for at least two years during the five year period prior to the exchange, A may exclude gain under § 121. Because the house is investment property at the time of the exchange, A may defer gain under § 1031.

A applies § 121 first to exclude \$250,000 of the \$270,000 gain before applying the non-recognition rules of §1031. A may defer the remaining gain of \$20,000 which was attributable to depreciation under § 1031. A's basis in the replacement property is \$440,000, which is equal to the basis of the relinquished property at the time of the exchange (\$190,000) increased by the gain under § 121 (\$250,000).

It should be noted that if the principal residence was received by the taxpayer through a like-kind exchange within the five years prior to the present sale, the \$250,000 exclusion (or \$500,000 exclusion for certain joint filers) does not apply. This new rule, part of the American Jobs Creation Act of 2004, applies to exclusions for sales or exchanges after October 22, 2004.

Andrew T. Chapeau



COURT REVERSES DETERMINATION THAT COBRA ELECTION NOTICE HAD BEEN MAILED

After an employee with Becton Dickinson was terminated, he sued his former employer for, among other things, failure to provide a COBRA election notice. The employer said that it sent an election notice via certified mail, return receipt requested (although no signed return receipt was ever received). The trial court ruled that the employer's method of delivering the election notice satisfied COBRA's requirements and granted the employer's motion for summary judgment (i.e., judgment without a trial) because the employer's custodian of records stated in a "sworn declaration" that the company had complied with COBRA's notice requirements. *Claudio-Gotay v. Becton Dickinson Caribe, Ltd.*

The employee appealed, and the First Circuit held that the trial court should not have ruled for the employer because there was not sufficient evidence that the notice had been mailed. The court ruled that the trial court should not have relied upon the "sworn declaration" because it was actually only a "note" stating that the notice had been sent by certified mail with an acknowledgement of receipt (including the date and certification number) and that the acknowledgement was never received. Attached to the note was U.S. Postal Service Form 381 (the green card that is attached to a piece of mail, signed by the recipient, and then returned to the sender), but there was no signature to indicate receipt by the employee and no

markings on the form showing that it was ever mailed. Because there was a factual issue as to whether the employer had given adequate notice as required by COBRA, the court reversed the trial court's decision and sent the case back for further proceedings.

*The Appellate
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even mailed.*

Plan administrators continue to face the challenge of not only complying with COBRA's notice requirements, but also proving that they have done so. Although the trial court discounted the absence of a signed return receipt in this case, the appellate court could not find sufficient evidence that the notice was even mailed. We continue to recommend mailing election notices by certified mail (with no return receipt requested) or first-class mail (with a certificate of mailing) in order to create a record of mailing while limiting the possibility of creating additional COBRA obligations for the plan administrator. This case also demonstrates the importance of actually retaining the mailing records so that evidence of providing COBRA election notices can be produced when necessary.

Brian J. McGrath

PROTECT YOURSELF IN TAX AUDITS

Getting a tax attorney involved early on in the process of a tax audit can be advantageous in many respects. While most taxpayers believe they have nothing to hide, when the IRS comes knocking their view often changes when the auditors uncover unknown problems. A good tax attorney understands that utilizing the attorney-client privilege and the work-product doctrine can protect taxpayers from disclosing protected communications and documents.

The attorney-client privilege protects communications between an attorney and his or her client. In the tax audit setting, a good tax attorney can also utilize the attorney-client privilege to protect communications between the attorney's client and other advisors to the client, such as the client's accountant. Oftentimes, a client's accountant has most of the documents needed in a tax audit, and it becomes very important that the communication between client and accountant with respect to the audit be protected by the attorney-client privilege. There are ways to facilitate such protection but only if your tax attorney is involved early on in the audit.

Furthermore, the complexities of determining what may constitute privileged communications or documents protected by the work-

product doctrine require the consultation of an attorney. For example, to qualify for protection under the work-product doctrine, a document or other work product must be created in anticipation of litigation. The question then becomes, under what circumstances are documents created "in anticipation of litigation?" Actual litigation does not have to be anticipated. It is sufficient that some type of adversarial proceeding, even if short of full-blown litigation, is expected. Even in situations where it is too early to know whether judicial intervention will ever be needed, if there is a realistic prospect that a contentious legal situation might develop, courts have held that such scenarios are "in anticipation of litigation."

In a tax setting, anticipation of an appeal within the Internal Revenue Service or the Nebraska Department of Revenue should qualify as a circumstance "in anticipation of litigation."

Note, however, that only documents created in anticipation of litigation will be protected under the work-product doctrine. In other words, documents created in the ordinary course of business will generally not qualify for protection. Most, but not all, courts agree that a "but for" standard provides a sufficient causal connection between the production of documents and the anticipation of litigation. In other words, if the documents would not

have been created but for the potential of litigation, then those documents should be protected under the work-product doctrine.

The issues taxpayers face in a tax audit are oftentimes more complex than they anticipate and unfortunately clients far too often consult with their tax attorney too late in the audit proceeding. So next time a tax auditor knocks on your door, consult with your tax attorney early in the proceeding so that your interests are protected from the beginning of the audit.

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