

RAUPC News

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Tax Shelters Headed To Slaughter The Government's Attack on Abusive Tax-Motivated Transactions

By Bob Underhill

Aided by accounting industry scandals and the brazen fashion in which a long series of tax schemes were marketed and distributed in recent years, the IRS and Congress have responded in slaughterhouse fashion. Using tactics and resources that practitioners never believed would have been employed against them, the government appears to be systematically identifying and challenging virtually every "tax shelter-type transaction" conceived by the best and brightest minds in the legal and accounting industries. Literally, there is nowhere to hide. Every indication is that most of these will, in fact, be overturned.

The large number of such deals, and the brains and reputations of major firms, once thought to be every advantage, is proving to be just the opposite. Most of the deals were probably, at one level or another, crude bets on winning the audit lottery. The intensity and effectiveness of the government's response have made the chances of winning that bet rather slim. The backing of the major accounting and law firms, which undoubtedly provided a great deal of security to clients and investors, now appears to be a mark—perhaps more like guilt by association. And the government appears not at all reluctant to hoist the reputations of these firms onto

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A Strange Estate

By Jay Hanson

A front-burner issue concerning estate planners is how to adapt to a recent string of IRS challenges concerning the operations of Family Limited Partnerships (FLPs) and Family Limited Liability Companies (FLLCs). Many of our clients have grown concerned over the past year with the frequency and high-profile nature of recent IRS successes against the use of FLPs/FLLCs to obtain valuation discounts for estate and gift tax planning purposes. Whether this is something to be overly concerned about still remains to be seen. However, what is known is that anyone currently operating an FLP/FLLC or seeking to establish one should adhere to a set of operational requisites and formalities to avoid some of the pitfalls which would assist the IRS in challenging the use of an FLP/FLLC for estate and gift tax planning purposes.

An FLP/FLLC is generally formed in order for a family to engage in inter-family transfers of appreciated assets or assets likely to appreciate. These transfers generally are made from older to younger generations and take advantage of available discounts to reduce transfer tax valuations. In addition to making inter-family gifts at reduced transfer tax valuations, such a gifting regime helps to reduce the overall value of the transferring party's estate; thereby reducing applicable estate taxes. A typical FLP/FLLC would be structured in the following manner: H and W set up an FLP or FLLC, transferring to it highly appreciated marketable securities. H and W's children, D and S, contribute a small amount of assets in exchange for an interest in the FLP or FLLC. Over time, H and W gift interests in the entity equal to the gift tax annual exclusion (e.g., \$11,000) to D and S each year to reduce their ownership interests in the FLP or FLLC to below 50%. Because valuation discounts imposed on the type of assets transferred can range up 35% or more, an \$11,000 gift made by H and W really could represent nearly \$15,000 of actual value transferred.

For years the IRS has been mounting challenges against FLPs/FLLCs, but with little success. That changed to some degree in 2003 when the IRS scored several victories against FLPs/FLLCs on both the gift and estate tax fronts. In *A. Hackl Estate* the FLLC operating agreement contained language which restricted the donees' rights to freely transfer or sell their interests in the FLLC.

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page one of the Wall Street Journal.

This article will give a bit of historical perspective, review what's happening with these deals and finally, provide an overview of recent Congressional action.

As long as there have been taxes, there have been people figuring out ways to avoid paying them. Our system is complex, and built on voluntary compliance. With the incidence of individual audits falling to below 1%, it is in the government's extreme interest that taxpayers believe that they are paying fairly—meaning that everyone is playing fairly. If faith in the system is undermined, the problems are obvious. Courts through the years have articulated common law doctrines of “substance over form” and thrown out “sham transactions” concocted by various taxpayers. But taxpayers win cases too.

In what might be called the “modern era” of tax law, the last widespread use of tax shelters was in the 1970s and early 1980s. The deals were different then. Enabled by strong business incentives built into the tax law, their use was encouraged by marginal tax rates (federal and state) that approached 80%. The deals were structured as limited partnerships, and packaged and distributed by syndicators and brokerages. They took advantage of highly advantageous rules of tax at the time regarding asset depreciation, expensing and tax credits, and involved investment in businesses favored by these rules—the biggest and most prolific involved oil & gas drilling, apartments and office buildings, motion pictures, cattle breeding, and later, cable TV. The money would come in from hundreds of investors per deal (the personal computer's first use in the tax industry was computing and generating K-1s). Investor money was substantially leveraged with bank debt. Many of the deals were decent investments, apart from the tax consequences—there really was oil, the building did appreciate, the movie made money. Even if the deal was a complete bust, 80% of the loss was underwritten by the government in



the form of tax savings and, considering time value of money (the tax write-offs came in multiples of the dollars invested), it was virtually a no-lose proposition. In the early '80s the deals got progressively worse—put together by pure financial players attracted by the money, people who didn't

know an oil well from any other hole in the ground, or who were willing to pay premiums for office and apartment property knowing the investor dollars were there. And the fees were big.

It went too far then, too. Sheltering was endemic among executives, doctors, wealth investors. Congress responded with a series of largely ineffective statutes to curtail it—one of which remains to have more of a bite today than it did back then: the AMT (alternative minimum tax). What finally killed it all was a staggering double barrel blast from the Reagan Administration's 1986 Tax Reform Act. The top tax rate (federal) fell all the way to 28%, taking away much of the incentive and the tax economics of the deals. And if that wasn't enough, the 1986 Act introduced the Passive Loss Rules, making it pretty near impossible to get tax losses into your return without spending 500 hours a year trying.

In the decade that followed the 1986 Tax Act, most of the tax sheltering activity was undertaken by major corporations. These involved financial transactions engineered around certain inadequacies of the tax code and were challenged by the IRS with mixed success in the courts. Beginning in the mid-1990s, the focus shifted to high net worth individuals, who were initially exempt from certain disclosure rules in the tax code and who, unlike major corporations, were rarely subjected to an IRS audit. The significance of the low incidence of IRS audits of individuals was never mentioned in marketing such deals, but was clearly a key factor in the minds of most investors. The chances of prevailing on the merits of the case were one thing, but “winning the audit lottery” was even better.

However, the transactional size and fee-paying capacity of most individuals is far less than for a major corporation. Consequently, the occasional high net worth individual client of a law or accounting firm who had the right facts and the right need for such strategies was not a meaningful revenue driver—not for firms who measure revenue in the billions of dollars. So a paradigm shift (to use the pop lingo of such firms at the time) took place in

the way and manner in which tax planning was delivered to such clients. In the old days, a client would apprise his or her tax advisor of a contemplated business or investment transaction and the advisor would creatively identify ways to arrive at

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Immediate Deductions Designed to Increase Business Investments

By Rainie McLaughlin

The Job Creation and Worker Assistance Act of 2002 brought relief to businesses by providing a 30-percent additional first-year depreciation allowance for qualifying property. By providing an immediate deduction, a business had an incentive to increase its investment activity. The incentive was made more appealing by the 2003 Tax Act which increased the additional first-year depreciation allowance to 50 percent. The special depreciation allowance is in addition to the regular depreciation deduction.

The 30-percent allowance applies to qualified property placed in service before May 6, 2003, and the 50-percent deduction applies to qualified property placed in service after May 5, 2003. Qualified property must meet the following criteria:

- It must be **new** property that is depreciated with a recovery period of 20 years or less.
- You must have acquired the property and placed it into service for use in your trade or business after September 10, 2001 (after May 5, 2003 for the 50% allowance).
- The original use of the property must have begun with you after September 10, 2001. "Original use" means the first use to which the property is put, whether or not by you.

An additional change reflected in the 2003 Tax Act affects upfront business write-offs. The upfront business write-off is commonly known as the Section 179 deduction. The maximum sec-

tion 179 expense you can deduct for property placed in service during 2003 has increased from \$24,000 to \$100,000. The maximum deduction begins to phase out if aggregate asset purchases (from all business activities) are more than \$400,000. Special limits apply to listed property and passenger vehicles, including trucks and vans.

Example:

Assume XYZ LLC acquires a new widget machine for a cost of \$300,000, new off-the-shelf software for \$25,000 and a used phone system for \$75,000. Assume all assets are placed in service mid-year. Total "qualifying additions" for Section 179 purposes are \$400,000, therefore entitling XYZ to expense \$100,000 of cost.

As the machinery and phone system have a 7-year depreciable life and the software a 3-year life, it is of greater benefit to elect Section 179 expense on the widget machine and phone system. As between those two assets, it is advantageous to elect Section 179 expense first to the extent of the cost of the phone system, as used equipment is not eligible for Bonus Depreciation. The \$100,000 expense election reduces the basis of the phone system to zero, and of the machine from \$300,000 to \$275,000 of remaining cost.

Only the widget machine and software are eligible for Bonus Depreciation in 2004 (used equipment does not qualify). Bonus depreciation on the widget machine is \$137,500 (\$275,000 of remaining cost times 50%); bonus depreciation on the software is \$12,500.

After the cost basis reductions for 179 and Bonus depreciation, the remaining basis is eligible for regular depreciation for the year.

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	Widget Machine	Software	Phone System	Total
Cost	\$300,000	\$25,000	\$75,000	\$400,000
179 Expense	-\$25,000	Not elected	-\$75,000	-\$100,000
Cost for Bonus	\$275,000	\$25,000	\$0	\$300,000
50% Bonus Depreciation	-\$137,500	-\$12,500	Not eligible	-\$150,000
Remaining Cost for Regular Depreciation	\$137,500	\$12,500	\$0	\$150,000
Regular Depreciation	\$10,643*	\$2,083**	\$0	\$21,726
Total Expense/Depreciation	\$157,143	\$14,583	\$75,000	\$246,726

Total depreciation/expense under the old (pre 9-11) rules would have been approximately \$178,000.

* \$137,500 remaining cost/7 years times 200% declining balance times ½ year convention

** \$12,500 remaining cost/3 years times ½ year

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the overall best tax answer. Ad hoc. One deal at a time. Meaning the business of giving tax advice, in firms of such size, was not exactly a “high growth” business. So, rather than a creative idea based on a given set of facts, it became a given set of facts based on a creative idea. Or, instead of clients in search of ideas, it was ideas in search of clients.

In truth, the right facts rarely existed. So a series of financial transactions was devised, with at least a theoretical chance for profit. A leading law firm was recruited to provide the comforting “tax opinion” (by the dozens). And the firms went hunting for clients. The fees were large—not quite Fortune 500 size, but there are many more high net worth individuals than Fortune 500 companies. According to some estimates, by 2001, these deals were providing as much as 15% of the revenues of the tax practices of the major accounting firms.

Perhaps to aid in marketing, the deals were known by acronyms—BOSS, Son of BOSS, BLIPS, POPS, COINS, CARDS, etc. They were lucrative enough that the firms developed marketing specialists—national or regional partners responsible for the solicitation and sale of such programs. The first such deals also routinely required that clients sign a confidentiality agreement. But later on that was rarely done—in part because the large firms readily pilfered each other’s ideas (putting on their own spin), but also because the law changed to require tax return disclosure of any transaction involving such agreements. Tax return disclosure was a complete deal killer, as it effectively removed any chance of winning the audit lottery.

In the final analysis, there were way too many of these deals sold (and bought by very willing investors). The cost to the Treasury was enormous and, without more effective enforcement, threatened to seriously undermine the integrity of the tax system. If some fantastic series of transactions can make basis appear in assets on the eve of their sale, or losses arise with little corresponding economic consequence, then the tax law truly isn’t working right. Even as to lawyers, accountants and other practitioners, it is beneficial in the long run if clients have faith in the system. In the late ’90s, it may have been that clients who brought “real facts” to the practitioner’s table got a more disciplined application of the tax code than clients who signed up for the latest tax shelter deal.

But the government’s response has been stunning and, for the most part, unanticipated. On the legislative front, there are new disclosure rules and stronger penalties—including penalties on practitioners who market such deals. The IRS has amassed a knowledge trove of the various deals

that were devised and marketed, and repeatedly updated what are known as “listed transactions.” The Service has raided the financial intermediaries for the identities of persons who participated in such transactions, and is now using this information to attack accounting and law firms for file information. The firms have fought back with lawyer/client and accountant/client privilege assertions, but the courts thus far have sided with the IRS and compelled disclosure.

To bring added pressure, a number of large accounting and law firms have landed in the Wall Street Journal in articles describing the extent of their involvement in such transactions. And the senior tax management of one international accounting firm was recently sacked in the face of intense pressure from several members of Congress and the Department of Justice.

Despite the thousands of such deals which proliferated, and the considerable manpower required of the IRS and other government agencies, there is little near-term prospect of generous settlement programs. The IRS is still gathering information through information requests and methodically obtaining consents to extend the statute of limitations, taxpayer by taxpayer. We may be a year or more away from any such cases being litigated and it may take some taxpayer success in the courts, or the threat thereof, to encourage the IRS toward meaningful offers of settlement.

Many taxpayers may bow out—those afraid of reputational damage or who simply do not want the anxiety of an ongoing IRS inquiry. Those taxpayers probably should never have entered into such deals in the first place. Others may be more pragmatic, and throw in the towel on the assumption that they lost the bet—the bet on winning the audit lottery. Certainly others, those with better facts, better advisors and/or stronger stomachs, may fight hard to keep their tax losses from the deals. However, the cost of staying in the fight will not be insubstantial.

One thing is important to note: most of these strategies were smartly devised and very reasonable interpretations of the tax code. Had they been implemented with a handful of well-chosen clients, based on real fact situations and real expectations of profit or gain, independent of tax consequences, each and every one would likely prevail. But “mass marketing” the same idea to hundreds of clients took a good idea too far.

Some firms and practitioners are facing the possibility of criminal sanctions. Some have been summoned to Congressional hearings led by Senators Carl Levin and Max Baucus probing tax shelter abuses. In response, several tax shelter bills have been introduced which would impose harsher penalties on tax shelter promoters (there was some testimony that promoters knowingly weighed the expected sales revenue from such

The government’s response has been stunning and, for the most part, unanticipated.

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activity against the possibility of rather modest penalties and made the “business call” to proceed). Such legislation would also codify the “economic substance” doctrine, a longstanding principle of the common law which demands consistency between the tax and economic outcomes of a given transaction.

For its part, the Treasury Department and IRS issued final regulations in March 2003 requiring taxpayers to disclose their potentially abusive tax avoidance transactions, promoters to register them, and advisors to maintain lists of clients who enter into them. As soon as it gains awareness, the IRS, through a series of announcements, has added potentially abusive transactions to its growing roster of “listed transactions” requiring tax return disclosure. In January of this year, Treasury announced a series of proposals included in President Bush’s ’05 Budget to close loopholes, halt several abusive transactions, raise penalties for failure to disclose and allow for injunctive relief against promoters.

From our vantage point, the combination of the above has pretty much brought tax shelter activity to a complete halt. For the time being, professional firms formerly at the vanguard of the industry are principally engaged in the repair of their reputations and in avoiding civil and criminal sanctions. For smaller promoters, new penalties have raised the stakes. But most importantly, taxpayers now view the chances of winning the audit lottery as slim indeed.

And in a recent speech to the Chicago Bar Association, the IRS Chief Counsel said that was exactly their aim. So for a while at least, great tax ideas are back to “one taxpayer at a time.”

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The strict transfer of interest restrictions, which are generally contained in a typical FLP/FLLC agreement, helped to negate the present interest rule necessary to qualify the gifts of the FLLC interests for the annual gift tax exclusion. The court found there was an absence of a present economic interest in the FLLC assets owned by the donees because they could not, in reality, sell, transfer or gift their interests in the particular entity.

This case may be a tempest in a teapot and its constrictions could be avoided by inserting a provision in an FLP/FLLC agreement which would give a donee the right to withdraw the assets underlying their interest in the entity for a stated period of time. Such a provision is analogous to a *Crummey* demand power which is commonly utilized in trusts to allow transfers to trust to qualify for the gift tax annual exclusion. Alternatively, the donees could be given greater rights to sell their FLP/FLLC interests, subject to certain rights of refusal which could be exercised by the other limited partners/members. This would create a situation much more analogous to a typical business arrangement. The presence of a right to withdraw the underlying FLP/FLLC assets or a right to transfer FLP/FLLC interests would greatly bolster an argument that a donee does in fact have a present interest in the entity’s underlying assets.

A more troubling development arose on the estate tax front in *A. Strangi Estate*, the third in a series of decisions from the seminal case *Strangi v. Commissioner* (“*Strangi II*”). Before *Strangi II*, FLP/FLLC discounting would fail if there was some type of inattention to the business formalities of the entity or if there existed outrageous circumstances, such as deathbed entity formations or lifetime transfers of nearly all of a decedent’s property to an entity. In *Strangi II*, the decedent, through his son-in-law, acting as his attorney-in-fact, created an FLP and a corporate general partner. The son-in-law transferred 98% of the decedent’s wealth, which totaled over \$9 million, to the FLP and corporate general partner (including the decedent’s residence). In return, the decedent received a 99% limited partnership interest in the FLP and a 47% ownership interest in the corporate general partner. The decedent’s children owned 52% of the corporate general partner and a charity owned the remaining 1%. The Tax Court concluded that the FLP was properly formed under state law and had sufficient substance to be recognized for estate tax purposes. However, the court concluded that the FLP and corporate general partner’s governing instruments contained no restrictions which prohibited the decedent, acting through his attorney-in-fact, from being designated as a recipient of the income from both the FLP and corporate general partner. Additionally, the court held that there ex-

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isted an implied agreement between the parties which allowed the decedent to retain the possession and enjoyment of the assets transferred to the FLP.

The Tax Court in *Strangi II* puts us on notice that the IRS may attempt to pull back into a decedent's estate the full value of transferred FLP/FLLC interests under certain circumstances. The judge in *Strangi II* acknowledged that the proverbial "i"s were dotted and the "t"s crossed, but such attentiveness to detail was not enough to defeat the presence of bad facts in this case. When the IRS deems that there are no substantial constraints on a transferor's control over the assets of an FLP/FLLC and the transferor is able to control distributions of such property, the IRS can pull the value of the FLP/FLLC interests back into a transferor's estate.

In some respects, *Strangi II* may provide a silver lining to an otherwise dark cloud. *Strangi II* helps to define the actions to be avoided with an FLP/FLLC. From *Strangi II* and its predecessors we learn that an FLP/FLLC must at a minimum be properly formed and managed free of questionable non-business-like circumstances. The presence of such negative factors can contribute to a determination that what should be an actively conducted business arrangement is nothing more than a charade used to leverage transfer tax discounts.

What are you, as an FLP/FLLC owner or someone contemplating the creation of an FLP/FLLC, to do? There are guidelines we can follow in the structure and operation of an FLP/FLLC. First, an FLP/FLLC must be properly formed through a written agreement which conforms to state law. There should also be a statement in the operating agreement stating the non-tax-related business motives for creating the entity. These motives can include the consolidation of invested assets to qualify for lower management fees, estate planning or asset protection purposes. There should be a period of time between the formation of the entity and the transfer of interests to other limited partners/members, and the FLP/FLLC assets should never be used to pay any transfer taxes associated with the transfer of interests. A transferor should never transfer virtually all of their liquid assets to the FLP/FLLC and should avoid transferring personal use assets such as a primary residence. Only pro rata distributions should be made to the partners/members, and if a distribution is something other than pro rata, such a distribution should be made in the form of an arm's length loan.

The entity should be kept in line with business realities. In this regard, the entity should use a bank account for all financial transactions and the transferor should never mix personal assets

with entity assets. An accountant should be retained to perform the entity's accounting and tax reporting functions, including the maintenance of the entity's capital accounts, books and records. The general partner or manager should sign all business documents and correspondence in his or her respective capacity as required under the entity's governing document. The entity should not be used as a pocketbook to transact personal business. Ultimately, a degree of control may need to be conceded to avoid the impression that the transferor continues, in any way, to control the use and enjoyment of the FLP/FLLC assets.

What can we as practitioners do? We recommend that the entity's operating agreement be drafted or amended to state that the general partner or manager have a fiduciary obligation when dealing with the limited partners or members. A strict fiduciary standard should be applied to any decisions concerning the distribution of FLP/FLLC assets. Alternatively, distributions of property could be postponed until the eventual termination or liq-

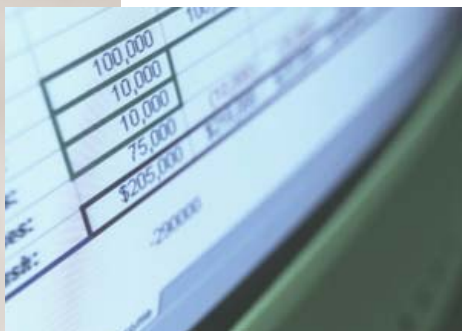


uidation of the entity. Operating agreements should be structured to avoid giving any partner or member the unilateral right to force the liquidation of the entity. In some cases it may be wise to incorporate a physician's letter into the business records detailing the health status of the transferor in order to avoid a charge that the entity was created in the face of poor health. Consideration should be given to gifting an interest in the entity to a non-family member and providing in the operating agreement that the independent donee must approve of any liquidation of the entity. A provision

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An FLP/FLLC must at a minimum be properly formed and managed free of questionable non-business-like circumstances.

Families with active businesses may be perfect candidates for creating the next generation of FLPs/FLLCs.



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analogous to a *Crummey* demand power or right of first refusal should also be incorporated into the operating agreement in order to maintain the viability of the gift tax annual exclusion for gifts of FLP/FLLC interests.

If the outcome of *Strangi II* and its progeny are as dire as some commentators suggest, then some new structuring realities may eventually accompany the creation or amendment of an FLP/FLLC. A technique to avoid the charge that a transferor controls the right of the use and enjoyment of the entity's assets would be to introduce real, independent third-party control over the

power to make distributions of the entity's assets. Such third-party control would also extend to the power to liquidate the entity. This would require the introduction of an unrelated neutral individual or entity who

would have the right to control the timing of distributions and liquidation. Another alternative could be to combine several unrelated parties with substantial economic interests together into a multi-member FLP/FLLC. In this regard, two or more families could create a single FLP/FLLC. Such an entity would operate much more like a true business entity and would take the right of control away from a single family member and share such powers with unrelated third parties. Finally, an FLP/FLLC conducting a bona fide business activity would serve as support for the economic realities accompanying the operation of a trade or business. Families with active businesses may be perfect candidates for creating the next generation of FLPs/FLLCs. When true economic realities of running a business are blended with an FLP/FLLC structure, the arguments supporting the IRS's position in *Strangi II* become much less compelling.

In most estate planning contexts, the transferor must part with control over an asset in order to enjoy a transfer tax reduction. The FLP/FLLC structure has long been viewed as a way to allow a transferor to retain some control over the entity's underlying assets and at the same time enjoy a reduction in transfer taxes. Those days may be in our rearview mirrors – but the eventual reach of *Strangi II* and how it will ultimately impact the operations of FLPs/FLLCs remains unclear.

What we do know is that the IRS is scrutinizing FLPs/FLLCs more than ever and is willing to litigate its position if the presence of bad facts exists. Your goal, as well as ours, is to keep those bad facts from developing in the creation and operation of your FLP/FLLC. An FLP/FLLC may not be the right estate planning technique for everyone, especially after the developments in *Strangi II* and *Hackl*. However, an FLP/FLLC can still serve an important function in both the estate and business planning arenas regardless of what stance the IRS takes regarding their operations. If you would like some more information on this topic please contact our office.

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RAUPC Stats Random Facts About Us

By Amy Bockelman

Percentage of RAUPC employees who own dogs	62.5
Percentage of those dogs that are Golden Retrievers	44.4
Percentage of those dogs that are Dachshunds	37.5
Percentage increase in number of RAUPC employees in 2003	60
Percentage of RAUPC employees whose first or last names start with the letter M	50
Weeks we have been waiting for our coffee table to arrive	19
Number of times we exchanged the sofa	1
Number of times we exchanged the conference room credenza	1
Number of parties our neighbors across the hall have had since we moved to our office space in January	6*
Percentage of RAUPC employees who had birthdays during busy season (February 15-April 15)	62.5
Percentage of those birthdays that were on April 10 or 11	60

*This figure is an estimate; only includes parties which we could see or hear, or to which we were invited.

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Tax Events Calendar

Date	Taxpayer	Event
June 15, 2004	Individuals	Second installment of 2004 estimated tax is due (Form 1040-ES).
June 15, 2004	Individuals	Due date for U.S. citizens and resident aliens living and working outside the U.S. and Puerto Rico to file income tax return (Form 1040) and pay any owed tax, interest and penalties.
July 15, 2004	Partnerships	Due date for filing 2003 income tax return (Form 1065 series) by calendar-year partnerships that obtained a three-month extension. Last day for filing Form 8800 to request an additional three-month extension.
August 2, 2004	Businesses	Washington Business and Occupation (B&O) tax return due for LLCs, partnerships and sole proprietorships who file quarterly.
August 16, 2004	Individuals	Due date for 2003 income tax return (Form 1040 series) by individuals who obtained a four-month filing extension. Last day for filing Form 2688 to request an additional two-month extension.
September 15, 2004	Individuals	Third installment of 2004 estimated tax is due (Form 1040-ES).

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