BEYOND ABEL
Ability to Pay
Guidance

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28 February 1993

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BACKGROUND

This manual is intended to provide guidance to U.S. Environmental Protection Agency enforcement staff on determining the ability of a violator to pay a penalty or environmental compliance costs. In particular, this guidance will help staff "go beyond ABEL" and assess ability to pay in those cases where the ABEL model produces a negative or ambiguous result.[1] Although ABEL is a useful screening tool, it is designed to be conservative. When an ABEL run produces a positive result, staff can be certain that the entity is able to pay. A negative or ambiguous result, however, does not necessarily indicate that the entity is <u>unable</u> to pay. ABEL may produce a negative result when, in fact, funds are available. This outcome may occur for several reasons:

(1) The violator might be able to produce a larger cash flow than that predicted by ABEL. ABEL bases its forecast on historical data from Federal tax returns. If the violator can pare its expenses, it can generate a larger cash flow.

(2) The violator might have assets that are not necessary to its business. These assets could be sold, generating funds for a penalty or pollution control costs. ABEL's analysis does not assess a company's assets.

(3) The violator might be able to assume more debt, or refinance debt that is owed to affiliated parties. ABEL's focus on cash flow does not directly evaluate a company's debt capacity.

This manual gives step-by-step instructions on how to investigate these issues. The manual contains worksheets to guide the user's analyses and draw attention to key information in the violator's tax returns and/or financial statements. Please note, however, that this approach will not produce a definitive ability to pay assessment, nor can any methodology. A final ability to pay

[1] ABEL is a computer model designed to assist enforcement staff in determining a violator's ability to pay a penalty and/or environmental cleanup costs. ABEL's assessments are based on financial data from the violator's tax returns.

assessment will require the user's judgment about the entity's financial capability and the degree of hardship that should be imposed on the violator. Such judgments are by their nature subjective, and will most likely be reached through discussion within the litigation team and enforcement staff.

Finally, bear in mind that the approach outlined here may not be sufficient for all entities. Cases involving entities with complex financial situations may require advice from a financial expert. Throughout the manual, we highlight those situations that could require this type of assistance.

Type of Entity

This manual focuses on analysis of private for-profit entities.[2] Separate worksheets and instructions are enclosed for:

- Subchapter C Corporations,
- Subchapter S Corporations,
- Partnerships,
- Sole Proprietorships, and
- Individuals.

Federal tax policy is different for each of the entities noted above, and each must submit different tax forms. The extent to which individual owners may be responsible for the liabilities of their businesses also varies among these entities. For example, sole proprietors and partners are personally liable for their businesses. Thus, in a bankruptcy case, creditors could pursue a sole proprietor's personal assets in order to clear the company's debts. Corporate shareholders, in contrast, are rarely held personally responsible for the company's liabilities.[3] The liability of individual shareholders in a closely-held Subchapter S Corporation, though, must often be determined on a case-by-case basis.

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[2] For-profit entities can generally be designated as either "private" or "public." Public for-profit entities are those whose equity (shares of stock) are traded in some form of open market (usually on one of the various Exchanges; e.g., NYSE, NASDAQ, and so forth). The equity of private for-profit entities, in contrast, is not traded publicly but is, rather, held by a group of individual investors (some of which may be institutions) who control the company.

[3] A corporation sets up a legal "veil" that shields its owners from personal liability. Hence the phrase "piercing the corporate veil" which is used when owners are found personally liable for a corporation's transgressions.

For each type of entity, the ability to pay assessment process detailed in this manual will help staff review ownership and operating affiliations, assets and liabilities, and expenses. Our goal in this review will be to determine if additional funds may be available. We will use examples throughout the manual to demonstrate how entities can arrange or use their resources so as to give the appearance of limited financial resources.

How This Manual is Organized

Chapter 2 of this manual outlines the ability to pay evaluation process, from information collection through final assessment, and discusses the analysis in detail. Chapters 3, 4, 5, and 6 review the analyses for Subchapter C Corporations, Subchapter S Corporations, Partnerships, and Sole Proprietorships, respectively. In Chapter 7 we discuss financial analysis of individuals, and the cases in which reviewing an individual's financial position (in addition to that of the business entity) may be appropriate. Appendix A contains a glossary of important accounting and finance terms and concepts.

GOALS

The primary goal of this guidance is to enable EPA regional staff to further analyze and make assessments about the ability of environmental violators to pay penalties. In undertaking this project, the Agency is aiming to provide a consistent and theoretically sound method for going beyond the ABEL result. Such consistency will increase the coherence and integrity of ability to pay analyses across EPA regions. It will also give enforcement staff a better understanding of private finance and accounting principles, and allow them to review cases more critically.

Another goal of this guidance is to provide a straightforward and relatively simply mechanism for reviewing an entity's financial position. The worksheets used in the analysis will help staff review financial information more quickly and will yield a clear and concise record of each case.

The basic investigation framework is similar across the entities we discuss here; however, there are some differences in the depth of the analysis and the financial information required for each. To accommodate these differences, we have written a separate chapter for each type of entity. The following segments of this manual are "stand alone" chapters. Each chapter contains instructions for researching a specific type of entity and completing the related worksheets.

FINANCIAL INFORMATION

Before conducting an in-depth investigation of an entity, staff must gather important financial information on the entity being analyzed. The amount of information available will likely depend on the type of entity (e.g., corporation, partnership, sole proprietorship) and its size. However, in all instances enforcement staff should obtain the following:

- Federal Income Tax returns from the past three years (these should already be available if an ABEL analysis has been conducted).[1] These returns are the primary source of financial information on the violator. Be certain that the returns are signed, and include all supporting schedules (these will be detailed in the entity-specific chapters). The worksheet-based analysis will be based on the most recent tax return available; however, you should also review past returns to see if the company's financial position has changed significantly over the past couple of years.

- Financial Statements from the past three to five years. Although tax returns are our primary source of financial information, financial statements are also helpful in that they provide some information generally not included in the tax returns. In particular, notes to the financial statements often contain important information on related-party transactions, loans to and from shareholders, and the company's accounting policies.[2] At a minimum, these statements should include an Income Statement and a Balance Sheet (see Appendix A for descriptions of these statements and other accounting terms). Companies might also be able to provide a Statement of Cash Flows (sometimes called: "Statement of Changes in Financial Position" or "Sources and Uses of Funds Statement").

  If at all possible, obtain audited Financial Statements from the entity. Audited statements are those which have been explicitly reviewed by a certified public accountant for their conformance with Generally Accepted Accounting Principles (GAAP). Audited statements will contain an auditor's opinion, which will summarize how closely the entity's financials conform with GAAP, and detail any questionable practices.[3] Small, unincorporated entities may only have unaudited statements.

  If an entity has no financial statements available, request that they prepare them. Even the smallest of sole proprietorships should be able to list and

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[1] Newly-formed companies will not have financial information going back several years. An ABEL analysis of a new company will probably not be possible because of the lack of historical financial data. Completing a detailed analysis as outlined in this guidance is particularly important for such entities.

[2] Also, financial statements may provide information on expenses not deducted on tax returns. For example, EPA or other penalties will appear on financial statements, but not on tax returns, as they are not tax-deductible.

[3] If you are reviewing an entity's audited financials and find a "qualified" auditor's opinion detailing questionable accounting practices, you should seek assistance from a financial analyst.

value its assets, liabilities, revenues and expenses.[4] Be cautious when you compare financial statements to tax returns, as the two can differ considerably. Tax returns and financial statements often report on a different time basis (i.e., calendar year versus fiscal year) or may use different accounting conventions. Keep these differences in mind when you compare the reported information.

- Dun & Bradstreet (D&B) Report. Dun & Bradstreet publishes information about companies as a service to potential investors or creditors.[5] D&B reports can be a good source of information on the entity's history, officers, and affiliations; they can sometimes provide comparative financial data on the entity as well. This information may help guide further research on the relationships to other individuals and entities. When you review a D&B report, keep in mind that companies voluntarily provide the underlying information. In doing so, companies often try to present a positive picture of their income position and potential earnings.

  D&B can also provide industry profiles. Other sources of information on industries and companies include Robert Morris Associates Annual Statement Studies, Value Line, Standard & Poor, and industry associations.

- Additional Financial Information. You might also find it helpful to review materials prepared by the company to support a recent loan or debt financing proposal, company forecasts of growth and/or expansion, and company plans for major capital expenditures. Such information can provide another measure of the company's anticipated future earnings.

It is important to note that accounting requirements differ for financial reporting and tax reporting. As a result, a company's tax returns and financial statements may report different numbers for some items.[6] Our analysis is based on the entity's tax returns. Review of the entity's financial statements is also important, however, as they may provide further detail on company activities and its relationships with other entities.

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[4] Note the time periods covered by Income Statements and Balance Sheets; ideally these should cover a full year of business operations. Statements covering only a portion of the year might not adequately represent the seasonality of some businesses.

[5] The National Enforcement Investigations Center (NEIC) can obtain D&B reports. The phone number is 303/844-4517.

[6] For example, reported income may be different from taxable income because of differences in claimed deductions.

APPROACH AND METHODOLOGY

The approach used in this manual applies commonly used financial analytical techniques to evaluate the financial condition of private entities. Once you have the necessary financial information, you can begin an in-depth review of the entity. This review will vary somewhat based on the type of entity, although the basic approach is very similar for each. Below, as an example, we review the steps for analyzing a corporation.

Ownership and Operating Affiliations

In many cases, companies closely related to the violator will share its financial liabilities. So, our first step in investigating an entity's financial position is to research its relationship with other entities. The goal of this first step is to determine the nature and extent of each affiliate's relationship, and whether you should also consider its resources in the ability to pay assessment. Some affiliations may be strong; if the violator is a division, for example, including the parent corporation is easy. Other cases may be more difficult to judge; for example, a case involving an American firm that is a subsidiary of a foreign parent. In these cases it will be important to determine the degree to which the parent company controls the financial health of the subsidiary. It is not necessary to prove that the parent is in any way liable for environmental costs. Rather, you are looking for financial resources available to the subsidiary outside its own legal structure.

Depending on the type of entity you are reviewing, the possible business affiliations will vary. For corporations, parent-subsidiary relationships and joint ventures might be an issue. In addition, the same person(s) may own "affiliated" corporations, and these might have significant financial interactions. For partnerships and sole proprietorships, you should look at the financial position of the general partners and/or the owner(s).

We will also want to examine an entity's "related party transactions." These transactions could include the sale or purchase of goods and services from an entity that is related to the violator via common ownership or family ties. Extensive related party transactions should be detailed in the entity's financial statements. In other instances, you might have to do some research on the violator's primary suppliers and customers to determine whether related parties are involved in the business. In subsequent chapters we discuss in greater detail the possible business relationships that different types of entities might have, and how they might affect your ability to pay assessment.

Business Assets

In this part of our investigation, we will look more closely at the assets recorded on the entity's Balance Sheet, posing a number of questions about their value and use. In particular we want to identify luxury assets (which may not be required for business purposes), undervalued assets, and loans to officers or shareholders.[7]

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[7] In some instances, a company balance sheet may show few assets as compared to liabilities, producing poor current and debt to equity ratios. You should review the historical financial documents of this company closely. If the company is doing poorly, the controlling owners may be

Luxury Assets

Luxury assets are those not necessary to the company's operations. Examples of such assets include land (particularly land that the company is holding as an investment or is renting to a second party), corporate airplanes or boats, and luxury vehicles. In examining these assets, consider whether selling them would materially affect the underlying business (e.g., What would happen if the company plane was sold?). If the asset is necessary to operations, consider how replacing it with a less valuable asset would affect the firm. What funds might become available (net any related loans) if the company officers replaced luxury company cars with more moderately priced models?

Undervalued Assets

Assets on the Balance Sheet are usually valued at their original purchase price ("cost") less accumulated depreciation. This net figure is known as the asset's "book value." The book value of an asset is highly influenced by the rate at which it is depreciated. Because companies can legally depreciate many of their assets over periods that are shorter than the assets' useful lives, book values can be considerably below market values. For example, suppose that a company buys a piece of equipment for $50,000, and that the equipment is expected to last for 10 years. On its tax return, the entity can depreciate the equipment over five years, with an annual straight-line depreciation expense of $10,000. After five years, this equipment still has a useful life of five years, and probably has a positive fair market value.[8] On the company's books, however, the asset is valued at zero.

The difference between book value and market value is generally not an issue for a company's Current Assets. For Property, Plant and Equipment, however, consider asking the entity to provide a list specifying both book <u>and</u> fair market values for all its assets worth more than $5,000. Assess for each major asset whether the stated market value seems reasonable, and whether it is greater than the stated book value. Any differences represent additional equity for the company.

Continuing with the example above, assume that the book value of the company's equity (i.e., its net worth after subtracting all liabilities) equals $200,000; and your review of the company's itemized list of assets indicates that the property, plant and equipment are worth $15,000 more than stated at book value. Add this $15,000 to company equity, increasing the total equity to $215,000.

Note that an asset examination does not imply that the company must use those assets as a source of penalty funds. In identifying these assets, we are simply indicating that the company has additional resources that could be used for penalty purposes. The company itself will determine how it will actually provide those resources.

"liquidating" the firm's assets (i.e., converting them to cash) and distributing the proceeds among company shareholders. Review the corporate tax return for sales of company assets (located on Form 4797 - Sales of Business Property).

[8] That is, it could be sold for some non-zero price.

Loans

Loans to Shareholders

Shareholders or corporate officers sometimes borrow from their companies at below-market interest rates, or obtain funds from the corporation that they would not be able to secure from a bank or other lender. Such loans must be reported on the Corporate Federal Income Tax return, and should always be considered as a source of penalty funds. By calling these loans (and requiring perhaps that these individuals borrow on the open market) the entity might be able to obtain resources necessary for a penalty.

Loans from Shareholders

Corporate entities must also report loans from shareholders on their Federal Income Tax returns. Shareholders can infuse funds into a company in one of two ways: (1) directly transfer funds to the company; or (2) provide funds as a loan. In the first case, if the company fails (i.e., goes bankrupt) the loss that the shareholder can claim on his or her personal income tax return is limited to $3,000 per tax year. In the second case, however, where the same shareholder makes a business loan to the company and the company fails, the entire amount of the loan can be written off as a loss. The potential tax advantages of such loans are obvious. The disadvantage of such a loan is that the interest the shareholder earns on it is taxable as income. In our analysis we will reclassify shareholder loans as business equity.

Business Expenses

The final worksheet examines the entity's expenses. A reduction in expenses (without a corresponding reduction in revenues) will increase an entity's cash flow, thereby improving its ability to pay. A company's expenses will be generally reported on its tax return, and on its Income Statement. We base our analysis on the entity's tax return; however, you should compare the tax return expense figures with those on the income statement (and any associated detail provided with both) and investigate any significant discrepancies. Companies often state their expenses at the highest allowable level for tax purposes to reduce their taxable income. If the documents that you have do not itemize expenses, request that the company furnish detailed information on specific expenses and service providers. Pay particular attention to officers' salaries, commissions, travel and entertainment expenses, rent or charges to affiliated entities, dues and publications, and office expenses. Look at whether any of these expenses (particularly rent, commissions, and sub-contracting) have been paid to related parties.

Officers' Salaries

Officers' salaries should be consistent with salaries earned by similarly-placed individuals. Professional societies and/or industry groups often collect statistics on earnings within their industries. The officers' salaries should also reflect the officers' respective duties, and the amount of time they spend on the job. Record this information on the worksheet and use it to determine whether officers' salaries are appropriate.

Other Expenses

Review the other expenses noted on the worksheet and try to evaluate their level and necessity. Note especially any expenses paid to related parties. Examples of such expenses include rent paid to an officer (i.e., the officer actually owns business property, perhaps under the name of a different entity), and subcontracting or service agreements with affiliates or relatives. Such "expenses" might actually disguise benefits or funds being paid to shareholders.

Data on average expenses within an industry or business are sometimes available from Robert Morris Associates Annual Statement Studies (depending upon the industry), or from industry associations. If you are uncertain about an expense, request additional information from the company. Evaluating a company's expenses involves judgment, and some familiarity with business operations. If you cannot determine whether an expense is reasonable, consult a financial analyst. If you decide that some of the entity's expenses are excessive, estimate the amount by which they can be reduced, and note these values on the worksheet.

Finally, remember that this expense review does not imply that the firm must reduce its expenses to provide penalty funds. Rather, this review simply identifies alternative sources of funds. The violator may choose a different approach from all those you identify. For example, the company may decide to maintain current expenses, and take out a loan to cover the penalty.

CASE DISPOSITION

After reviewing the company's financial information and investigating its holdings and transactions, you can reassess the violator's ability to pay. This assessment will vary depending on the entity, but will generally consist of two steps: (1) a simple cash flow calculation; and (2) an equity assessment. The steps described below focus on a corporation. The assessment of an individual's cash flow and equity is detailed in Chapter 7.

Cash Flow Calculation

Part of the ABEL Model's ability to pay assessment is a cash flow calculation. ABEL incorporates into its cash flow calculation several technical considerations, including the inflation rate, reinvestment rate, and estimates the present value of an entities anticipated cash flows. Our "manual" calculation is much easier. To estimate cash flow, we start with taxable income and add back all "paper" deductions (e.g., non-cash expenses), and consider the effect of reduced expenses.

As a first step, we add back depreciation, amortization and depletion. These non-cash expenses allow companies to account for asset value reductions over time (for example, business equipment or depletable natural resources). Depreciation and amortization are legitimate business costs, however, they are not cash payments and thus do not increase a company's annual cash outflows. For that reason, we add these non-cash expenses back into income when computing net cash flow. Similarly, depletion accounting is a way to allocate over time the original cost of acquiring and developing natural resources.[9] Although depletion is a legitimate business cost, it does not represent a cash outflow. Thus, we also add any depletion expenses back into a company's income when computing cash flow.

As an example, assume that Company ABC's taxable income for a year is $86,000, and the company claimed $4,115 in depreciation for that year. Adding back the latter amount gives us an estimated cash flow of $90,115. This last amount, rather than the original taxable income figure, represents ABC's actual pre-tax cash flow.[10]

Next, we adjust cash flow for any possible expense reductions that you have identified in your "Beyond ABEL" investigation, yielding an estimate of cash flow that could possibly be generated if expenses were reduced (assuming, of course, that revenues do not change). Suppose that your investigation shows that the company can reduce officers' salaries by a total of $20,000, and other expenses by another $5,000. Adding $25,000 to actual pre-tax cash flow ($90,115) yields an estimated pre-tax cash flow figure of $115,115.

The final step is to adjust this figure for taxes.[11] We do so by multiplying the pre-tax cash flow by one minus the marginal tax rate.[12] Next we must add to this figure the "tax benefit" of any depreciation, depletion or amortization deductions; plus any net operating losses carried forward from previous years.[13] To obtain this tax benefit figure, we multiply the total of these non-cash deductions by the marginal tax rate. Company ABC did not claim any net operating loss carry-forwards on its most recent tax return. Therefore, we estimate after-tax cash flow at $72,380 ($115,115 x [1 - 0.385] + $4,115 x 0.385). This estimate does not imply that company cash flow <u>will</u>, in fact, equal $72,380 next year; it simply provides an estimate of the resources that <u>might</u> be available to the company if it continues to perform at its "adjusted" current level.

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[9] For example, a coal-mining company would record depletion expenses every year to account for the coal that had been mined that year. Each year the mines are less valuable because they contain less coal. Recording depletion is a way of capturing that loss.

[10] Although we refer to this figure as "pre-tax cash flow" you should note that certain state and local taxes can be deducted from income as a company expense. Thus "pre-tax" here refers to cash flow before <u>federal</u> income tax payments.

[11] Recall from your ABEL calculations that pollution control expenditures are tax deductible, while a penalty is not. In general we will estimate an entity's ability to pay based on after-tax cash flows.

[12] For corporations, we use 38.5 percent as the standard tax rate. For partnerships, sole proprietorships and Subchapter S corporations we use 33 percent, the highest marginal tax rate for individuals.

[13] A net operating loss carryforward is an ABEL input, and is claimed on Line 29a of the Form 1120 and Line 25a of the Form 1120A. Companies can claim some prior years' losses as current deductions. The adjustment we state here accounts for tax effects of the non-cash loss.

Equity Assessment

In assessing a company's equity we want to determine two things: (1) the value of assets that could be liquidated without materially changing the business; and (2) the equity of the entity, based on the value of remaining assets.

Assume that the fictitious ABC Company's equity equals $456,400. First we summarize information you've gathered about unnecessary or luxury assets. Suppose you discover that ABC owns and maintains four high-priced vehicles with a total current market value of $110,000, and no associated loans. While these vehicles are necessary for business-transportation purposes, you believe that they could be replaced with more moderately-priced vehicles, which would have a combined market value of $70,000. Replacing these vehicles would free up approximately $40,000.

Suppose that you also discover that the company has an outstanding loan of $12,000 to one of its officers. Having the officer repay this loan would also make funds available for a penalty.

Now we want to recalculate the company's equity, based on the market value of its assets and any possible reductions in liabilities. Based on your review of a detailed list of assets, you actually decrease the value of the ABC's total assets from $1,205,000 to $1,153,000. This decrease reflects the $40,000 downgrade in luxury business vehicles, and removal of the $12,000 officer's loan. The combined amount ($52,000) is no longer considered a company asset, but rather becomes "excess funds" available for a penalty. Your review of ABC's liabilities indicates that they are legitimate and accurately represented. If we assume that these liabilities equal $748,600, we can then recalculate stockholder's equity as $404,400, down from an original value of $456,000. Company ABC may be able to borrow against this amount to produce funds for a penalty.

Case Disposition

The final section of the worksheet summarizes your results. In your investigation, you estimated that ABC's after-tax cash flow for the coming year could be as high as $72,380. The value of unnecessary or replaceable assets equals $52,000 ($40,000 from the vehicle sale plus $12,000 from the officer loan), and the adjusted equity for the company is estimated at $404,400. The violator's ability to pay pollution control and/or penalty costs can now be reassessed based on these approximations.

If the violator is required to pay a penalty only, you can compare your ability to pay assessment to the penalty figure directly, since a penalty is a "one-time" payment. However, if environmental compliance costs are also involved (e.g., the company must invest in pollution control equipment) you will need to consult your original ABEL analysis.

To adjust for required pollution control expenditures, do the following: First, re-run the ABEL model <u>without</u> entering a penalty figure. Does the result still show that the violator will have a difficult time paying environmental compliance costs? If so, compare your revised estimate of pre-tax cash flow and cash available from asset liquidation to the pre-tax present value of compliance costs.[14] Any indication that the violator will still experience difficulty is a serious issue, as the violator must, at a minimum, come into compliance to continue operating. If the comparison indicates that the violator is able to meet compliance costs, note on the worksheet any remaining funds available for a penalty.

Remember that this summary does not imply that the company must liquidate assets or call in loans to produce penalty funds. Rather, your review is aimed at more accurately assessing the resources that the entity has to call upon. Any final ability to pay figure will clearly incorporate the judgment of the enforcement team regarding what is appropriate given the violation.

GUIDANCE STRUCTURE

The approach described in this manual is organized around the various tax forms that an entity might file: Form 1120 or 1120A for Subchapter C corporations, Form 1120S for Subchapter S corporations, Form 1065 (with Schedule K-1) for Partnerships, and Form 1040 for Individuals and Sole Proprietorships (with Schedule C for the latter).

The guidance is structured around the tax return forms primarily because each return (and hence each type of entity) requires a "customized" analysis. Also, the tax forms let us reference specific schedules and line items that are important to the analysis. As you proceed through the worksheets, you will be able to consult the corresponding tax return forms.

[14] The present value of compliance costs is simply the difference between "Total ABEL Cash Flow Generated" (column 2 of the ABEL summary analysis) and "ABEL Cash Flow Net of Pollution Control Expenditures" (column 3). The difference between these figures at <u>any</u> probability level equals the present value of compliance costs. Divide this amount by one minus the marginal tax rate to estimate costs on a pre-tax basis.

SUBCHAPTER C CORPORATIONS — CHAPTER 3

INTRODUCTION

Regular corporations (also known as Subchapter C corporations) can be large, multi-company organizations or small, "closely-held" companies controlled by a few individuals or a family. When such a business incorporates, it takes on the legal status of an individual. Therefore, responsibility for paying debts and meeting other legal commitments rests with the corporation alone, and does not extend to the corporate shareholders.[1] In some respects, this liability limitation makes a corporate ability to pay analysis fairly easy, as the financial resources of the owners need not be assessed. However, relationships that corporations enter into with other business entities can complicate the evaluation, and will sometimes lead to an analysis of these other entities.

You will most likely have completed an ABEL analysis for the corporation you are reviewing, and are now consulting this document because of a negative or equivocal ABEL result. The objective of this more detailed analysis is to determine if, despite a negative ABEL result, the company can provide funds for a penalty by, for example, liquidating assets, reducing expenses, or borrowing funds.

The first step in this analysis is to gather financial information. The corporation's Federal Income Tax return Form 1120, and the relevant schedules, will already be on hand if you've performed the ABEL analysis.[2] You should also obtain the company's financial statements (e.g., income statement and balance sheet) for the past three to five years. Most corporations should be able to provide audited statements (i.e., statements that have been reviewed by a certified public accountant).

Consider also collecting other information on the company (e.g., Dun & Bradstreet or Standard & Poor reports), as well as information on earning and expense averages, and performance

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There are exceptions to this general rule. Under certain circumstances, liability for debts and penalties can extend to the company's shareholders.

Note that some corporations may fill out the 1120A (Short-Form). The requirements for completing the short-form are detailed on page 2 of the <u>Instructions for Forms 1120 and 1120A</u> booklet.

norms within the corporation's industry. These other sources could provide helpful information on company affiliations and officers, and on industry trends. Once you have collected the necessary information, you can begin the ability to pay evaluation using the worksheets at the end of this chapter as a guide. Be certain, however, to read Chapter 2 before proceeding, as it contains a more detailed explanation of the worksheet sections.

Section I - General Information

The first section of the worksheet summarizes basic information about the violator and the information that has been collected:

- **Violator's name.** On Line 1, enter the violator's name.
- **Address.** On Line 2, enter the violator's address.
- **Principal business activity and product or service.** On Line 3, enter the violator's principal business activity, along with its product or service.[3] This information is on the Corporate Income Tax return Form 1120, Schedule K lines 2b and 2c.[4]
- **Names of Officers.** On Line 4 enter the names of the corporate officers and the percent of stock owned. This information can be found on Schedule E on Form 1120.
- **Original penalty amount.** Note on Line 5 the proposed penalty amount.
- **Penalty as a percent of sales.** Divide the original penalty amount by the company's total sales (item 1a on form 1120). Note the result on Line 6.

Section II - Financial Information

In this section of the worksheet we summarize the financial information available.

- **Tax returns and schedules available.** On Line 7, note the tax returns and schedules provided, along with the year for each return.

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[3] Note that an ability to pay evaluation may be particularly difficult for certain businesses; for example, agricultural corporations participating in government subsidy programs. You may want to consult an expert for help in assessing these types of entities.

[4] Throughout this chapter, references to Form 1120 are for the 1991 version of Form 1120. The location of items may differ for previous years' forms.

- **Financial Statements provided.** On Line 8, list each available financial statement (e.g., Balance Sheets, Income Statements and notes, Statement of Change in Financial Position). Is this an audited statement? Note the period covered by the statement, particularly if the statement covers only a portion of the fiscal year.

- **Other violator or general industry information collected.** On Line 9, list any other material you have obtained. Examples include Corporate Annual Reports, Dun & Bradstreet reports, Value Line reports, Standard & Poors industry data, etc. Note as well the dates covered by the document(s).

<u>Section III - Ownership and Operating Affiliations</u>

In this section we detail the relationships that the violator may have with other entities. This section is particularly important for corporations that are connected to other entities through parent-subsidiary relationships, joint venture agreements or other affiliations. These relationships are described in greater detail below. You might be able to obtain information on these relationships through the company's annual reports or its D&B report. In particular, you will want to determine whether an affiliate is closely involved in the operations or finances of the violator.

Subsidiaries

A subsidiary is a corporation that is at least 50-percent owned by another company (i.e., at least 50 percent of its common stock is owned by one other corporation). A subsidiary is <u>wholly</u> owned if the parent company owns 100 percent of its stock. As with all corporations, a subsidiary is an individual legal entity. As such, it may file separate tax returns. However, if a subsidiary is more than 80 percent owned by the parent company, the parent may submit a consolidated tax return that incorporates the subsidiary. For financial reporting purposes, according to generally accepted accounting principles, a consolidated statement should be prepared if:

- The parent owns more than 50 percent of the common stock of the subsidiary;

- The parent is able to exert control over the operation and management of the company; and

- The asset and equity structure of the subsidiary is not significantly different from that of the parent.

The extent to which parent and subsidiary are related is quite important in ability to pay cases. A parent company can often enter into purchasing contracts with a subsidiary, or manipulate its finances, such that its financial condition appears worse than would be the case were the subsidiary an independent concern.[5] Your evaluation of the parent-subsidiary relationship might indicate that the parent company should be included in an ability to pay assessment of the subsidiary. Although it is not EPA's policy to pronounce a parent firm liable for a subsidiary's actions, it is proper to consider financial links that the subsidiary may have to the parent. It some instances it might be difficult for enforcement staff to determine how involved the parent is in the operations of a subsidiary. If you are unsure whether the parent should be included in the ability to pay assessment, consult a corporate finance expert.

Affiliated Companies

Affiliated companies are those that are owned or controlled by the same individual or group. Also known as "brother-sister" companies, control is demonstrated if:

- Five or fewer persons (individuals, estates, or trusts) own at least 80 percent of the voting stock or share value of each of two or more corporations; and

- These five or fewer persons own more than 50 percent of the voting power or share value of each corporation.

Brother-sister corporations can enter into the same type of purchasing agreements discussed above for subsidiaries. In some instances, a corporation will choose to enter into a risky venture by creating an affiliate, thereby limiting the liability for its other concerns. As with subsidiaries, you should consider the financial links among a group of brother-sister corporations when determining the ability to pay of a single affiliate.

Joint Ventures

A joint venture is a business activity collectively established by two or more entities. Each participating entity invests in the new company and shares in its income. Major decisions for the company often require the backing of all owners. A joint venture operates as a separate entity, and will generally submit its own tax returns. However, if an ABEL analysis indicates that a joint venture is unable to provide funds for a penalty, the resources of the holding companies should be evaluated.

Worksheet

An audited set of financial statements should include a section in the notes on any related party transactions. This section will detail sales and purchases of goods and services from the violator's affiliates. This section in the notes is helpful for two reasons: (1) it helps to identify the violator's affiliates; and (2) it can be used to assess whether related party transactions were conducted "at arms length" (i.e., at fair market rates). In this section of the worksheet, we detail

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[5] See the ABEL User's Guide, Chapter 5, for additional information on this topic.

related-party transactions. If the notes to the Financial Statements do not provide this information for the entity you are analyzing, you should request that the company provide the information.

- **Additional business concerns.** Is this corporation affiliated with any other business concerns? Check yes or no on Line 10.

- **Entity information.** For each related entity, note the name and type. For example:

Affiliate's Name	Type of Entity
MCG Demolition	Corporation

- **Relationship and percentage owned.** Describe here the relationship between the two entities. Note also the percentage of stock owned by the affiliate. Also note transactions between the affiliates. For example:

Relationship and percentage ownership
MCG Demolition is a 'sister firm of MCG Construction, which owns 25 percent of its stock. MCG Construction accounts for 20% of MCG Demolition's Sales. The two companies frequently purchase materials or services from each other.

In the summary portion of this worksheet section (Line 11), discuss whether other entities should be included in the ability to pay assessment for this violator. In some instances, this determination will require advice from a financial expert. Continue to work on the ability to pay assessment of the violator while you pursue information about the corporation's affiliates.

Section IV - Business Assets

In this section of the worksheet, we review the corporation's assets, and investigate their use and worth. Remember that our intention is to determine the true ("market") value of the company's assets, and the funds that might be available through liquidation of those that are unnecessary.

Part A - Loans to Shareholders

As explained in Chapter 2, loans to shareholders and officers are among the first assets that should be tapped to fund a penalty. These loans must be reported on Form 1120, Schedule L, Item 6.

Request that the violator provide additional information on the terms of these loans before completing the following section on the worksheet:

- **Borrower.** Enter the name of the officer or shareholder borrowing funds.
- **Date and amount of loan.** Note the original amount of the loan and the date on which funds were borrowed.
- **Interest rate.** Note the interest rate at which the funds were borrowed.
- **Amount outstanding and date.** Enter the amount outstanding (loan balance) as of the most recent financial statement or tax return.
- **Total outstanding loans to shareholders.** Total here the outstanding amount of all loans to officers and/or shareholders and enter this figure on Line 12.

Part B - Luxury Assets

In this section, our goal is to determine whether the company owns luxury or unnecessary assets, or whether its balance sheet understates its assets, and thereby its net worth. As stated in Chapter 2, luxury assets might include expensive or unnecessary vehicles, boats, planes, rental property, or other assets not necessary to the company's operations.

In general, we will focus on the corporation's most valuable assets. Although it may be possible to identify these assets using financial statements or tax returns, you might want to request that the corporation provide a list specifying both the book and market value of assets valued at over $5,000, as well as their use to the company. Information on asset use is important for determining whether the asset is essential to company operations. Review the list that you receive carefully. Do the market values seem reasonable? The worth of some assets can be double-checked against outside sources. For example, vehicle values are published in industry "blue books," available at car dealerships. County or local property assessors should be able to verify the value of land and/or buildings in their jurisdiction. Industry analysts or associations can often estimate the value of business or industrial equipment.

In some instances, an entity will not want to provide detailed information on its assets, or it may delay in doing so. If the penalty is significant, you may want to invest resources in researching state transportation files, FAA records, or an asset database for this information.[6] Remember that your ability to pay analysis will only be as accurate as the data you receive. Remind entities that if they do not provide financial data, you cannot evaluate their inability to pay claim.

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[6] Information America maintains an on-line asset locator database for a number of U.S. counties. They can be contacted at 1-800/235-4008 for information on fees and data sources.

Once you have reviewed a corporation's assets, complete the following block of information for each luxury asset that you discover:

- **Asset and use.** Describe the asset (for example, note make and year of vehicles or equipment, location or property) and its use. In this section you may also want to explain why you consider this asset to be a company "luxury."

- **Estimated market value.** Note the market value of the asset and the source for this information.

- **Balance due on loan.** Note here any remaining loans outstanding on this asset.

- **Replacement cost.** Estimate the cost of substituting luxury assets being used by the company with less expensive replacements. For example; company officers may need vehicles to conduct business, but they don't necessarily need luxury vehicles.

- **Potentially available.** To estimate funds potentially available for this asset, subtract the outstanding loan amount from its market value.

- **Total potentially available net of replacement.** Subtract any replacement costs from the value of luxury assets and enter the net amount available on Line 13.

Part C - Undervalued Assets

In this section, note on the worksheet any discrepancies between the book value of an asset and its market value:

- **Asset.** Describe the asset (for example, note make and year of vehicles or equipment, location of property).

- **Book value.** Note the value as stated on the company's financial statements or tax return (Schedule L on Form 1120).

- **Estimated market value.** Note the market value of the asset and the source for this information.

- **Total estimated excess value of assets.** Calculate the difference between market and book value for each undervalued asset and enter the sum on Line 14.

Section V - Loans from Shareholders

As noted in Chapter 2, loans from shareholders represent investment in the company, and thus, for ability to pay purposes, can be considered company equity. These loans are claimed as a separate liability on Form 1120, Schedule L, Item 18. You might also want to request additional information from the corporation on loan terms and use of these funds.

- **Lender.** Enter the name of the officer or shareholder lending funds.

- **Date and amount of loan.** Note the original amount of the loan and the date on which funds were advanced.

- **Amount outstanding and date.** Enter the amount outstanding as of the most recent financial statement or tax return.

- **Total outstanding loans.** Sum the outstanding amount of all loans from officers and/or shareholders and enter the total on Line 15.

- **Revised liability total.** Subtract the total loan amount from liabilities and enter the revised total on Line 16 (Total liabilities equal Items 16 through 21 on Form 1120, Schedule L).

Section VI - Business Expenses

In this section of the worksheet we evaluate the level and necessity of the corporation's expenses. Corporate expenses are listed as deductions on Form 1120, Items 12 through 26. Be certain to examine any attached statements that detail expenses under Item 26 "Other deductions." Also, it is a good idea to compare expenses on the tax return to those specified on the company's income statement.[7] Any significant discrepancies between the two should be investigated.

Part A - Officers' Salaries

- **Officer.** Note each officer's name as it appears on Schedule E, Item 1a.

- **Percent of time devoted to business.** Schedule E, Item 1c details the time spent by each officer on corporate business. Enter that information here.

- **Salary.** Note here each officer's salary as it is claimed on Schedule E, Item 1f.

- **Amount of reduction.** Evaluate a reduction in officers' compensation, based on your review of the duties, time commitment, income, and percent ownership of each officer.

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[7] As mentioned earlier, company financial statements may include some expenses that are not included in corporate tax returns. Penalties payable to any government entity are an example of this (e.g., OSHA or IRS penalties). You may want to include these expenses in your analysis. Also, be aware that collection on IRS penalties generally takes precedence over EPA penalties. Finally, in your comparison of tax returns and financial statements, note that annual tax returns and income statements may not cover the same time periods. If the periods covered are different, consult a financial analyst.

- **Total reductions.** Sum the reductions and enter the total on Line 17.

- **Justification for reductions.** If possible, provide some information about each officer's role or duties in the company and a justification of any possible salary reductions. This information will not appear on the tax returns; however, it may appear in the corporate annual report or the company's D&B report.

Part B - Other Expenses

In your review of company expenses, pay particular attention to travel and entertainment or subsistence expenses, vehicle expenses, rent, office expenses and supplies, and dues and membership fees. Such expenses can mask funds going to corporate officers or employees (for example, vehicle expenses may include personal use of vehicles).

Also examine expenses paid to related parties, particularly subcontractor expenses, and expenses for professional services.

- **Expense category.** Review the corporation's expenses and list those that you believe can be reduced without materially affecting the operations of the company.

- **Amount expended.** Note the current annual amount for each expense that you believe can be reduced.

- **Possible reduction.** Enter the amount by which you feel this expense could be reduced without affecting company operations.

- **Total possible reduction in expenses.** On Line 18, sum all possible expense reductions.

- **Justification for reduction.** In this space, describe your reasons for each proposed reduction.

Section VII - Case Disposition

In this section of the worksheet we review the information we have gathered on corporate holdings and transactions. As explained in Chapter 2, this summary leads to a reassessment of the company's ability to pay. We will calculate (1) cash flow, and (2) corporate equity.

Part A - Cash Flow

If you conducted an ability to pay assessment of this violator using ABEL, then you already have an estimate of the corporation's current and anticipated cash flow. In our analysis, we re-calculate cash flow, using adjusted income and expense figures. This calculation is detailed in the steps below:

- **Taxable income.** On Line 19 enter taxable income as reported on Form 1120, Item 28 (Taxable income before net operating loss and special deductions).

- **Depreciation, depletion and amortization expenses.** In Chapter 2 we explained that depreciation, depletion and amortization are expenses that do not affect a company's cash flow. We therefore add these expenses back into company income. Sum the amounts claimed on Form 1120, Lines 20 and 22 and enter the sum on Line 20 of this worksheet.

- **Pre-tax cash flow.** Sum the amounts on Lines 19 and 20. This total represents the company's pre-tax cash flow.

- **Reductions in officer's salaries.** On Line 22, enter the amount from Line 17 in Section VI, Part A of this worksheet.

- **Reductions in other expenses.** On Line 23, enter the total from Line 18 in Section VI, Part B of this worksheet. Recall from Chapter 2 that this amount must be converted to an after-tax figure.

- **Estimated pre-tax cash flow.** Add the amounts on Lines 22 and 23 above to pre-tax cash flow.

- **Tax adjustment.** Multiply this amount by one minus the corporate marginal tax rate (1- 0.385) and enter the result on Line 25.

- **Non-cash deduction tax benefits.** Add together the amount on Line 20 and any net operating loss carry forward that has been claimed, and multiply the total by the tax rate (0.385) and enter the amount on Line 26.

- **Estimated after-tax cash flow.** Add lines 25 and 26 for estimated after-tax cash flow.

As an example, assume that the MCG Construction Company's most recent tax return lists taxable income before special deductions as $63,790. MCG has claimed a total of $44,500 in equipment depreciation. Adding this to the company's declared taxable income gives us an adjusted income figure of $108,290. This total represents MCG's pre-tax cash flow for that fiscal year.

Next we summarize possible expense reductions. According to its return, MCG is not currently compensating it officers, so this expense cannot be reduced. Most other expenses also seem reasonable, with the exception of the company's $178,211 insurance expense. You are not sure what policies are included in this expense, so you ask the company for a list specifying the policies it holds. The information provided indicates this expense includes whole-life insurance policies which the company has purchased for its officers. These policies are not really a cost of doing business, but are rather a form of officer compensation. You estimate that the company's insurance expense could be reduced by $25,000 if officers were responsible for their own life insurance policies. If income remains fairly constant and these expenses are reduced, then MCG could generate an estimated $133,290 in pre-tax cash flow.

To adjust for taxes we first multiply this amount by one minus the corporate marginal tax rate (1-0.385 = 0.615) for an tax-adjusted subtotal cash flow of $81,973. We then add back the tax benefit of MCG's $44,500 depreciation deduction, which equals $17,133 ($44,500 x 0.385). MCG has not carried forward any losses from previous years, so it final estimated after-tax cash flow equals $99,106 ($81,973 + $17,133).

Part B - Equity Assessment

In assessing MCG's equity we want to determine: (1) the value of assets that could be liquidated in order to provide penalty funds; and (2) the true equity of the company, based on the value of remaining assets.

<u>Asset Liquidation</u>

We determine funds that the corporation may be able to readily produce to fund a penalty as follows:

- **Value of loans to shareholders.** On Line 28, enter the amount from Line 12 in Section IV, Part A of this worksheet.
- **Estimated excess value of luxury or unnecessary assets.** On Line 29, enter the amount from Line 13 in Section IV, Part B of this worksheet.
- **Estimated funds available from liquidation.** Sum the figures on Lines 28 and 29 and enter the total here. This estimate represents resources that could possibly be directed towards a penalty payment.

<u>Equity Valuation</u>

Here we summarize other information gathered on company assets and liabilities in order to more accurately estimate company equity.

- **Adjusted company assets.** Enter the total value of company assets. To calculate this figure, subtract the value of assets liquidated (Line 30) from the value of company assets as it appears on Form 1120, Schedule L, Item 15.
- **Estimated incremental value of undervalued assets.** Enter the value on Line 14 of Section IV, Part C of this worksheet.
- **Adjusted total assets.** Sum the figures on Lines 31 and 32 for an estimate of the company's assets.
- **Adjusted liabilities.** Enter the revised total for company liabilities from Line 16 in Section V of this worksheet.

- **Estimated adjusted equity.** Subtract Line 34 from Line 33 and enter this figure on Line 35. This is an estimate of the company's equity, based on adjustments to assets and liabilities.

Continuing with our example company, MCG Construction, we illustrate the equity assessment. MCG's assets, per its balance sheet, are $542,700; its liabilities equal $346,960, for total equity of $195,740. Your review of the company's assets indicates that MCG does not have any apparent luxury or unnecessary assets. However, several years ago the company lent $15,000 to one of its officers. Approximately $11,000 is still outstanding on this loan, which was made at an annual interest rate of three percent. Liquidating this loan (i.e., calling it in) will reduce notes receivable (a company asset) by $11,000. We assume that this amount will be directly applied to a penalty or environmental costs, and therefore include it in assets to be liquidated. Subtracting the $11,000 loan from our original asset figure of $542,700 gives us a revised asset figure of $531,700. All liabilities on the company statements appear legitimate, and you calculate a new equity total of $184,740. MCG could potentially borrow funds against this amount.

Part C - Case Disposition

The final section of the worksheet summarizes your results. In your investigation, you estimated MCG's after-tax cash flow at $99,106 (enter this amount on Line 36). You also determined that MCG could furnish $11,000 by calling in a loan made to one of its officers (enter this on Line 37). Adjustments that you made to the company's assets indicate that equity in MCG Construction equals approximately $184,740 (enter this on Line 38). Compare these amounts to the assessed penalty figure and/or environmental compliance costs as discussed in Chapter 2. As a final step, note whether this investigation completes the analysis or if analysis of affiliated entities is required.

Remember that this summary does not imply that the company must produce funds through the sources you have identified. Rather, your review is aimed at more accurately assessing the resources that the entity has to call upon. Any final ability to pay figure will clearly incorporate the judgment of the enforcement team regarding what is appropriate given the violation and original penalty amount.

CORPORATION

EXTENDED ABEL ANALYSIS

Section I. General Information

1. Violator's name:	
2. Address:	
3. Principal business activity and product or service (1120 Schedule K lines 2b and 2c):	

4. Names of Officers (1120 Schedule E or attached Statement)	Percent ownership of stock

5. Original penalty amount	
6. As a percent of sales (penalty ÷ 1120 line 1a)	

Section II. Financial Information

7. Tax returns and schedules available	Year Prepared

CORPORATION

EXTENDED ABEL ANALYSIS

Section II. Financial Information (continued)

8. Financial Statements provided	Audited? Y or N	Period(s) covered

9. Other violator or general industry information collected and date of document(s):

CORPORATION

EXTENDED ABEL ANALYSIS

Section III. Ownership and Operating Affiliations (from tax form, Financial Statements and/or D&B report)

Additional business concerns (check and answer where applicable)	Yes	No
10. Is this corporation affiliated with any other business concerns (e.g., subsidiaries, parent corporations, sister companies, joint ventures, etc.)		

If Yes, provide the following information:

Affiliate's Name	**Type of entity**	**Relationship and percentage ownership**

11. **Summary: Discuss possible expansion of Ability to Pay analysis, and additional information required.**

CORPORATION

EXTENDED ABEL ANALYSIS

Section IV. Business Assets (Use data from 1120 Schedule L, compare with Financial Statements)

Part A. Loans to Shareholders

Borrower	Date and amount of loan	Interest rate	Amount outstanding (date)
12. Total outstanding loans to shareholders			

Part B. Luxury Assets

Asset and use	Estimated market value	Balance due on loan	Replacement cost	Potentially available
13. Total potentially available net of replacement				

CORPORATION

EXTENDED ABEL ANALYSIS

Section IV. Business Assets (continued)

Part C. Undervalued Assets

Asset	Book value	Estimated market value	Value difference
14. Total estimated excess value of assets			

CORPORATION

EXTENDED ABEL ANALYSIS

Section V. Loans from Shareholders

Lender	Date and amount of loan	Amount outstanding (date)
15. Total outstanding loans		
16. Revised liability total		

Schedule A Cost of Goods Sold (See instructions.)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs (see instructions) *(attach schedule)*	4	
5	Other costs *(attach schedule)*	5	
6	**Total.** Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on line 2, page 1	8	

9a Check all methods used for valuing closing inventory:
(i) ☐ Cost
(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4
(iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c)
(iv) ☐ Other (specify method used and attach explanation) ▶ ....

b Check if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)* ▶ ☐

c If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO | 9c |

d Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☐ Yes ☐ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation.

Schedule B Other Information

		Yes	No
1	Check method of accounting: (a) ☐ Cash (b) ☐ Accrual (c) ☐ Other (specify) ▶		
2	Refer to the list in the instructions and state your principal: (a) Business activity ▶ .... (b) Product or service ▶		
3	Did you at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing: (a) name, address, and employer identification number and (b) percentage owned		
4	Were you a member of a controlled group subject to the provisions of section 1561?		
5	At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See instructions for exceptions and filing requirements for form TD F 90-22.1.)		
	If "Yes," enter the name of the foreign country ▶		
6	Were you the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		
7	Check this box if the corporation has filed or is required to file **Form 8264,** Application for Registration of a Tax Shelter ▶ ☐		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If so, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	If the corporation: (a) filed its election to be an S corporation after 1986, (b) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, and (c) has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) ▶ $........		
10	Check this box if the corporation had subchapter C earnings and profits at the close of the tax year (see instructions) ▶ ☐		

Designation of Tax Matters Person (See instructions.)

Enter below the shareholder designated as the tax matters person (TMP) for the tax year of this return:

Name of designated TMP ▶ ________ Identifying number of TMP ▶ ________

Address of designated TMP ▶ ________

Form **1120S**

Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

For calendar year 1991, or tax year beginning ...., 1991, and ending ...., 19 ....

▶ See separate instructions.

OMB No. 1545-0130

1991

A Date of election as an S corporation

B Business code no. (see Specific Instructions)

Use IRS label. Otherwise, please print or type.

Name

Number, street, and room or suite no. (If a P.O. box, see page 8 of the instructions.)

City or town, state, and ZIP code

C Employer identification number

D Date incorporated

E Total assets (see Specific Instructions)
$

F Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address (4) ☐ Amended return

G Check this box if this S corporation is subject to the consolidated audit procedures of sections 6241 through 6245 (see instructions before checking this box) . ▶ ☐

H Enter number of shareholders in the corporation at end of the tax year . . . ▶

Caution: *Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.*

Income	1a	Gross receipts or sales ______ b Less returns and allowances ______ c Bal ▶	1c	
	2	Cost of goods sold (Schedule A, line 8)	2	
	3	Gross profit. Subtract line 2 from line 1c	3	
	4	Net gain (loss) from Form 4797, Part II, line 18 *(attach Form 4797)*	4	
	5	Other income (see instructions) *(attach schedule)*	5	
	6	**Total income (loss).** Combine lines 3 through 5 ▶	6	
Deductions (See instructions for limitations.)	7	Compensation of officers	7	
	8a	Salaries and wages ______ b Less jobs credit ______ c Bal ▶	8c	
	9	Repairs	9	
	10	Bad debts	10	
	11	Rents	11	
	12	Taxes	12	
	13	Interest	13	
	14a	Depreciation (see instructions) — 14a		
	b	Depreciation claimed on Schedule A and elsewhere on return — 14b		
	c	Subtract line 14b from line 14a	14c	
	15	Depletion **(Do not deduct oil and gas depletion.)**	15	
	16	Advertising	16	
	17	Pension, profit-sharing, etc., plans	17	
	18	Employee benefit programs	18	
	19	Other deductions *(attach schedule)*	19	
	20	**Total deductions.** Add lines 7 through 19 ▶	20	
	21	Ordinary income (loss) from trade or business activities. Subtract line 20 from line 6	21	
Tax and Payments	22	**Tax:**		
	a	Excess net passive income tax *(attach schedule)* — 22a		
	b	Tax from Schedule D (Form 1120S) — 22b		
	c	Add lines 22a and 22b (see instructions for additional taxes)	22c	
	23	**Payments:**		
	a	1991 estimated tax payments — 23a		
	b	Tax deposited with Form 7004 — 23b		
	c	Credit for Federal tax on fuels *(attach Form 4136)* — 23c		
	d	Add lines 23a through 23c	23d	
	24	Estimated tax penalty (see page 3 of instructions). Check if Form 2220 is attached ▶ ☐	24	
	25	**Tax due.** If the total of lines 22c and 24 is larger than line 23d, enter amount owed. See instructions for depositary method of payment ▶	25	
	26	**Overpayment.** If line 23d is larger than the total of lines 22c and 24, enter amount overpaid ▶	26	
	27	Enter amount of line 26 you want: **Credited to 1992 estimated tax** ▶ ______ **Refunded** ▶	27	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer — Date — ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ — Date — Check if self-employed ▶ ☐ — Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ — E.I. No. ▶ — ZIP code ▶

INTRODUCTION

Corporations that meet specific criteria can elect to be organized as Subchapter S corporations. Specifically, the corporation must:

- Be a domestic corporation.
- Have only one class of stock.
- Have no more than 35 shareholders.
- Have as shareholders only individuals, estates, and certain trusts. Partnerships and corporations cannot be shareholders in an S corporation.
- Have shareholders who are citizens or residents of the United States.

In general, Subchapter S corporations are fairly sophisticated vehicles for conducting business, and analyzing their ability to pay can be difficult. Income from a Subchapter S corporation is apportioned to shareholders, and is reported and taxed on each shareholder's individual tax return. However, this "income" does not represent a cash payment to the shareholder, as would wages, for example. All or much of the income may be retained within the corporation. Because this income is taxed at the shareholder level, though, a share must be claimed on each individual tax return. Any cash or property distributed to shareholders will be recorded as such on the Form 1065 Schedule K (Line 17 - Total property distributions other than dividends, and Line 19 - Total dividend distributions paid from accumulated earnings and profits).

Individuals sometimes form Subchapter S corporations as tax shelters, as business losses can offset shareholders' income and thereby reduce their taxes. Often, too, small businesses initially incorporate under Subchapter S, and later reorganize under Subchapter C as the business begins to generate income.

Because analyzing Subchapter S corporations can be complicated, we recommend that you seek advice from a financial analyst under the following conditions:

- If the corporation did not have S corporation status for the entire year of its most recent tax return;
- If any distributions of property are reported on Line 17;
- If a high percentage of the corporation's income is investment income (i.e., if the sum of Lines 4 through 4f account for more than 30 percent of total income); or
- If the corporation is generating a loss, rather than generating income (i.e., if it is reporting negative income).

Since Subchapter S corporations may have no more than 35 shareholders, they are often organized and controlled by families or small groups of individuals. The term "closely-held" refers to those corporations that are controlled by one person or very few individuals. It is therefore important with such corporations to investigate potential intermingling of corporate and individual shareholders' funds. As discussed in Chapter 1, such intermingling could "pierce the corporate veil" that protects shareholders from personal responsibility for the corporation's liabilities. We pay particular attention to this possibility here, as such intermingling is more likely to occur in small, closely-held corporations.

You probably will have already performed an ABEL analysis for the Subchapter S corporation and are consulting this document to identify additional sources of funds. This more detailed analysis provides a methodology for evaluating the company's income, assets and expenses to determine if they are reasonable. Small companies may be able to manipulate financial information to avoid taxes, or to mask funds going directly to shareholders. This analysis will highlight those items which should be investigated more carefully before making a final ability to pay assessment.

Since corporate financial information will provide the basis for this analysis, you must first collect all relevant materials. If you have performed an ABEL analysis you will already have the corporation's Federal Income Tax return Form 1120S and the relevant schedules on hand. These will be our primary source of information, although financial statements would also be useful. Audited statements (i.e., those that have been reviewed by a CPA for their conformance with generally accepted accounting principles) are the most reliable, but at the very least the Subchapter S corporations should be able to provide unaudited financial statements.

Subchapter S corporations are private entities. As a result, independent financial information may be more limited than that available for publicly-traded corporations. Dun & Bradstreet provides financial information for a number of private companies. These reports often include corporate history, financial statistics and a listing of corporate officers. In addition you may be able to locate industry earnings and expense averages and performance norms for similar types of businesses. These sources could provide useful information to supplement your ability to pay analysis.

Once you have collected the necessary information, you can begin the ability to pay evaluation using the worksheets at the end of this chapter as a guide. Be certain before proceeding, however, that you have read Chapter 2, as it contains a more detailed explanation of the worksheet sections.

Section I - General Information

The first section of the worksheet summarizes basic information about the violator and the information that has been collected:

- **Violator's name.** On Line 1, enter the violator's name.
- **Address.** On Line 2, enter the violator's address.
- **Principal business activity and product or service.** On Line 3, enter the violator's principal business activity, along with its product or service.[1] This information is on the 1991 Corporate Income Tax return form 1120S, Schedule B lines 2a and 2b.
- **Original penalty amount.** Note on Line 4 the original penalty amount proposed.
- **Penalty as a percent of sales.** Divide the original penalty amount by the company's total sales (item 1a on form 1120S). Note the result on Line 5.

Section II - Financial Information

In this section of the worksheet we summarize the available financial information:

- **Tax returns and schedules available.** On Line 6, note the tax returns and schedules provided, along with the year for each return.
- **Financial Statements provided.** On Line 7, list each available financial statement (e.g., Balance Sheets, Income Statements and notes, Statement of Change in Financial Position). Is this an audited statement? Note the period covered by the statement, particularly if the statement covers only a portion of the fiscal year.
- **Other violator or general industry information collected.** On Line 8, list any other material you have obtained and/or researched (e.g., Dun & Bradstreet reports, industry statistics, etc.) Note also the dates covered by the documents.

[1] Note: you may want to consult a financial analyst if the Subchapter S corporation is a farming or agricultural operation, as these entities can be difficult to analyze.

Section III - Ownership and Operating Affiliations

Unlike Subchapter C corporations, Subchapter S corporations are restricted from entering into certain business relationships. In general, a Subchapter S corporation cannot be a member of an affiliated group of corporations and therefore cannot have subsidiaries.[2] In addition, the corporation itself cannot be a subsidiary or joint venture because the individual shareholders cannot be corporations or partnerships. While these constraints limit the organizational complexity of a Subchapter S corporation, they do not restrict its affiliations entirely. A Subchapter S corporation may still hold stock in other corporations, and can be a member of a partnership. For tax purposes, companies are assumed to be affiliated with other organizations if they own 50 percent or more of the stock in the entity, or if they are a partner.[3] Such affiliated entities should be reviewed if you decide to extend your ABEL analysis beyond the Subchapter S corporation itself.

Part A - Corporate Affiliates

In this section provide any information you have obtained regarding corporate affiliates and the relationships they have to the Subchapter S corporation. First, on Line 9, check whether the corporation is affiliated with any other entity.

- **Affiliate's name.** On Line 10 enter the name of the affiliate.
- **Type of entity.** Enter the type of organization (e.g., corporation, partnership).
- **Relationship and percent ownership of stock.** List the percent of stock in the affiliated entity owned by the Subchapter S corporation. Provide any additional information regarding the relationship between the two entities, particularly if they are involved in any transfers of goods and services.

Part B - Shareholders and Officers

This section of the worksheet asks for detailed information on majority shareholders (i.e., those owning more than 20 percent of the stock), their affiliates (if known), and the distributions they receive from the business. This section will enable you to identify the key shareholders who may be included in the extended ABEL analysis, should personal and corporate funds overlap. Specific shareholder information can be found on the K-1 Schedules, attached to the Subchapter S corporation tax returns. You might also be able to obtain information on corporate officers through D&B reports:

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[2] There are exceptions to this rule in cases where a subsidiary is inactive, a former Domestic International Sales Corporation (DISC), or a foreign corporation. For more information consult Tax Information on S Corporations, Publication 589 from the IRS.

[3] For more information regarding the requirements on corporate affiliations and related parties see Tax Information on S Corporations, Publication 589 from the IRS.

- **Shareholder and corporate position.** Enter on Line 11 the name(s) of the shareholders owning 20 percent or more of the company's stock. Note also whether each is a corporate officer (this information might be noted on the D&B report).

- **Percent ownership.** Schedule K-1, Item A specifies the shareholders ownership share in the business.

- **Dividends/distributions.** Note property distributions to each shareholder as reported on Line 17 of each individual Schedule K-1.

- **Information regarding shareholder affiliations.** Note here any information that has been provided regarding majority shareholders' affiliations, and whether the Subchapter S corporation does any business with the affiliated entity.

Section IV - Business Assets

In this section of the worksheet, we review the corporation's assets and investigate their use and worth. Remember that our intention is to determine the true ("market") value of the company's assets, and the funds that might be available through liquidation of any that are unnecessary.

Part A - Loans to Shareholders

As explained in Chapter 2, loans to shareholders and officers are among the first assets that should be tapped to fund a penalty. These loans must be reported on Form 1120S, Schedule L, Item 7. Note on the worksheet some detailed information about these loans:

- **Borrower.** Enter the name of the officer or shareholder borrowing funds.

- **Date and amount of loan.** Note the original amount of the loan and the date on which funds were borrowed.

- **Interest rate.** Note the interest rate at which the funds were borrowed.

- **Amount outstanding and date.** Enter the amount outstanding as of the most recent financial statement or tax return.

- **Total outstanding loans.** Total here the outstanding amount of all loans to officers and/or shareholders and enter this figure on Line 13.

Part B - Luxury Assets

In this section, our goal is to determine whether the company is holding luxury or unnecessary assets, or is undervaluing its assets and thereby understating its equity. As stated in Chapter 2, luxury assets might include luxury or unnecessary vehicles, boats, planes, rental property, or other assets not necessary to the company's operations.

In general, we will focus on the corporation's more valuable assets. Although it may be possible to do so using financial statements or tax returns, you might want to request that the corporation provide a list specifying both the book and market value of assets valued at over $5,000, as well as their use to the company. Information on asset use is important for determining whether the asset is essential to company operations. Review the list that you receive carefully. Do the market values seem reasonable? The worth of some assets can be double-checked against outside sources. For example, vehicle values are published in industry "blue books," available at car dealerships. County or local property assessors should be able to verify the value of land and/or buildings in their jurisdiction. Industry analysts or associations can often estimate the value of business or industrial equipment.

In some instances, an entity will not want to provide detailed information on its assets, or it may delay in doing so. If the penalty is significant, you may want to invest resources in researching state transportation files, FAA records, or an asset database for this information.[4] Remember that your ability to pay analysis will only be as accurate as the data you receive. Remind entities that if they do not provide financial data, you cannot evaluate their inability to pay claim.

Once you have reviewed a corporation's assets, complete the following block of information for each luxury asset that you discover:

- **Asset and use.** Describe the asset (for example, note make and year of vehicles or equipment, location or property) and its use. In this section you may also want to explain why you consider this asset to be a company "luxury."

- **Estimated market value.** Note the market value of the asset and the source for this information.

- **Balance due on loan.** Note here any remaining loans outstanding on this asset.

- **Replacement cost.** Estimate the cost of substituting luxury assets being used by the company with less expensive replacements. For example, company officers may need vehicles to conduct business, but they don't necessarily need luxury vehicles.

[4] Information America maintains an on-line asset locator database for a number of U.S. counties. They can be contacted at 1-800/235-4008 for information on fees and data sources.

- **Potentially available.** To estimate funds potentially available for this asset, subtract the outstanding loan amount from its market value.

- **Total potentially available net of replacement.** Subtract any replacement costs from the value of luxury assets and enter the net amount available on Line 14.

Part C - Undervalued Assets

In this section, note on the worksheet any discrepancies between the book value of an asset and its market value:

- **Asset.** Describe the asset (for example, note make and year of vehicles or equipment; location of property).

- **Book value.** Note the value as stated on the company's financial statements or tax return (Schedule L on Form 1120S).

- **Estimated market value.** Note the market value of the asset and the source for this information.

- **Total estimated additional value of assets.** Calculate the difference between market and book value for each undervalued asset and enter the sum of all values on Line 15.

Section V - Loans from Shareholders

As noted in Chapter 2, loans from shareholders represent investment in the company, and thus for ability to pay purposes can be considered company equity. These loans are claimed as a separate liability on Form 1120S, Schedule L, Item 19. You might want to request additional information from the corporation on loan terms and use of these funds.

- **Lender.** Enter the name of the officer or shareholder lending funds.

- **Date and amount of loan.** Note the original amount of the loan and the date on which funds were advanced.

- **Amount outstanding and date.** Enter the amount outstanding as of the most recent financial statement or tax return.

- **Total outstanding loans.** Total here the outstanding amount of all loans from officers and/or shareholders. Enter this amount on Line 16.

- **Revised liability total.** Subtract the total loan amount from liabilities and enter the revised total on Line 17 (Total liabilities equal Items 16 through 21 on Schedule L, Form 1120 S).

Section VI - Business Expenses

In this section of the worksheet we evaluate the level and necessity of the corporation's expenses. Corporate expenses are listed as deductions on Form 1120S, Items 7 through 19. Be certain to examine any attached statements that detail expenses under Item 19 "Other deductions." Also, it is a good idea to compare expenses on the tax return to those specified on the company's income statement.[5] Any significant discrepancies between the two should be investigated.

Part A - Officers' Salaries

Here we assess compensation paid to officers for the duties they perform. Officers of a Subchapter S corporation may or may not be shareholders in the corporation. As officers they earn a salary, which is different from income earned by shareholders. Unlike the 1120 tax form for Subchapter C corporations, the 1120S does not request detailed information regarding officer compensation. Total officer compensation is noted on line 7 of the 1120S; however, this compensation is usually allocated among multiple officers.

To fill out this portion of the worksheet you will need to request detailed information regarding officers' compensation and duties. Dun and Bradstreet reports might provide a list of corporate officers. With this information you can assess whether compensation is reasonable based on officers' duties, and whether it can be reduced to provide additional funds for penalty payment.

- **Officer.** Note each corporate officer's name as it appears on the D&B report or corporate financial statements.

- **Salary.** Note the salary each officer receives for performing duties.

- **Amount of reduction.** Estimate a reduction in each officer's compensation, based on their respective duties, time commitment, income and percent stock ownership.

- **Total reduction in officer's salaries.** On Line 18, sum all possible reductions in officers' salaries.

- **Summarize duties and provide justification for reductions.** Summarize the officers' duties and time devoted to corporate activities. Provide justification for any proposed reductions.

[5] Be aware in your comparison that annual tax returns and income statements may not cover the same time periods, or may be based on different accounting methods.

Part B - Other Expenses

In your review of company expenses, pay particular attention to travel and entertainment or subsistence expenses, vehicle expenses, and office expenses and supplies.[6] Such expenses can mask funds going to corporate officers or employees (for example, vehicle expenses may include personal use of vehicles). Examine as well any expenses paid to a related party; particularly expenses paid for subcontractors or professional services.

- **Expense category.** Review the corporation's expenses and list those that you believe can be reduced without materially affecting the company's operations.

- **Amount.** Note the current annual amount for each expense that you believe can be reduced.

- **Possible reduction.** Enter the amount by which you feel this expense could be reduced without affecting company operations.

- **Total possible reduction in expenses.** On Line 19 sum all possible reductions in expenses.

- **Justification for reduction.** In this space, list your reasons for each proposed reduction.

Section VII - Case Disposition

In this section of the worksheet we review the information we have gathered on corporate holdings and transactions. As explained in Chapter 2, this summary leads to a reassessment of the company's ability to pay. This analysis has two steps: (1) a cash flow calculation, and (2) an equity assessment.

Part A - Cash Flow

If you conducted an ability to pay assessment of this violator using ABEL, then you already have an estimate of the corporation's current and anticipated cash flow. In our analysis, we re-calculate cash flow using adjusted income and expense figures. This calculation is detailed in the steps below:

- **Taxable income.** On Line 20 enter taxable income as reported on Form 1120S, Item 21 (Ordinary income [loss] from trade of business activities).

- **Depreciation, depletion and amortization expenses.** In Chapter 2 we explained that these expenses do not affect a company's cash flow. Therefore

[6] Note that corporations can only deduct 80% of certain travel and entertainment expenses. Therefore, a lower expense might be reported on the tax return than is reported on the financial statements.

we add these expenses back into company income. Sum the amounts claimed on Form 1120S, Lines 14a and 15 and enter the total on Line 21.

- **Pre-tax cash flow.** Sum the amounts on Lines 20 and 21. This total represents the company's pre-tax cash flow.

- **Reductions in officers' salaries.** On Line 23, enter the amount from Line 18 in Section VI, Part A of this worksheet.

- **Reductions in other expenses.** On Line 24, enter the total from Line 19 in Section VI, Part B of this worksheet.

- **Estimated pre-tax cash flow.** Add the amounts on Lines 23 and 24 above to estimate pre-tax cash flow.

- **Tax adjustment.** Multiply the amount on Line 25 by one minus the highest marginal income tax rate for individuals (1 - 0.33 = 0.67) and enter the result on Line 26.[7]

- **Non-cash deduction tax benefits.** Multiply the amount on Line 21 by the tax rate (0.33) and enter the result on Line 27.

- **Estimated after-tax cash flow.** Add together Lines 26 and 27, and enter the result on Line 28.

The corporation might be able to produce this amount in the coming year if income remains steady and expenses are reduced. Recall that this income is not distributed as <u>cash</u> to shareholders. Although shareholders must pay taxes on their portion of income, the cash they receive is recorded as distributions and dividends on Schedule K.

As an example, let's assume that Clever Designs Advertising Company's most recent tax return lists net income from trade or business activities of $87,550. Clever Designs has claimed a total of $22,450 in equipment depreciation. Adding this to the company's declared ordinary income gives us an adjusted income figure of $110,000. This total represents Clever Designs' pre-tax cash flow for the fiscal year.

Next we summarize possible expense reductions. According to its return, Clever Designs is not currently compensating its officers (the company is run by two officers, each of whom owns 50 percent of the stock), so this expense cannot be reduced. Most other expenses also seem reasonable, with the exception of the company's $17,500 travel and entertainment expense. Upon investigation you find that $7,500 of this amount was used for vacations taken by the company's president and her family. Therefore, you determine that travel and entertainment expenses can be reduced by this entire amount. If income remains fairly constant and expenses are reduced, then

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[7] We use the individual income tax rate (rather than the corporate rate) because income from Subchapter S corporations is taxed at the shareholder level.

Clever Designs could generate an estimated $117,500 in pre-tax cash flow ($110,000 + $7,500). Adjusting for taxes, this amount translates into $78,725 ($117,500 x 0.67). Next we calculate the tax benefits of Clever Designs' non-cash deductions. We multiply the depreciation expense by the tax rate ($22,450 x 0.33) for a tax benefit of $7,409. We add this amount to the $78,725 for a total estimated after-tax cash flow of $86,134.

Part B - Equity Assessment

In assessing Clever Design's equity we want to determine: (1) the value of assets that could be liquidated to provide penalty funds; and (2) the true equity of the company, based on the value of remaining assets.

Asset Liquidation

We determine funds that the corporation may be able to readily produce to fund a penalty as follows:

- **Value of loans to officers or shareholders.** On Line 29, enter the amount from Line 13 in Section IV, Part A of this worksheet.

- **Net value of luxury or unnecessary assets.** On Line 30, enter the amount from Line 14 in Section IV, Part B of this worksheet.

- **Estimated funds available from liquidation.** Sum the figures on Lines 29 and 30 and enter the total on Line 31. This estimate represents resources that could possibly be directed towards a penalty payment.

Your investigation of Clever Designs indicates that they have one outstanding loan to a shareholder in the amount of $7,600. Assuming that this loan can be liquidated and the shareholder can obtain funds elsewhere, this adjustment would provide additional funds for penalty payment. Remember to subtract this amount from company assets, as calling in the loan will remove it as a note receivable.

Equity Valuation

Here we summarize other information gathered on company assets and liabilities to more accurately estimate company equity.

- **Adjusted company assets.** Enter the adjusted value of company assets. To calculate this figure, subtract liquidated assets from assets as they appear on Form 1120S, Schedule L, Item 15.

- **Estimated incremental value of undervalued assets.** Enter the value on Line 15 of Section IV, Part C of this worksheet.

- **Adjusted value of assets.** Sum the figures on Lines 32 and 33 for an estimate of the company's assets.

- **Adjusted liabilities.** Enter the revised total for company liabilities from Line 17 above on Line 35.

- **Estimated adjusted equity.** Subtract Line 35 from Line 34 and enter this figure on Line 36. This is an estimate of the company's equity, based on adjustments to assets and liabilities.

Continuing with our example company, Clever Designs Advertising, we illustrate the equity assessment. Clever Design's assets, per its balance sheet, are $240,600; its liabilities equal $155,650, for total equity of $84,950. Your review of the company's assets indicates that Clever Designs does not seem to be holding any undervalued assets; however, a loan to a shareholder equalling $7,600 is outstanding. We subtract this amount from assets, as these funds can be applied to a penalty. The adjusted asset figure equals $233,000. Also, one of the company shareholders lent the firm $5,000 several years ago. The loan from the shareholder is effectively an equity infusion. Thus we reduce liabilities by the loan amount. Our new equity total equals $82,350.[8]

Part C - Case Disposition

The final section of the worksheet summarizes your results. In your investigation, you estimated Clever Designs' potential after-tax cash flow of $86,134 (enter this on Line 37). Also, you determined that Clever Designs could furnish $7,600 by calling in a loan made to one of its shareholders (enter this on Line 38). Adjustments that you made to the company's liabilities indicate that equity in the company equals approximately $82,350 (enter this on Line 39). As a final step, note whether the analysis of the Subchapter S corporation is completed, or will be extended to affiliated entities.

Remember that this summary does not imply that the company must produce funds through the sources you have identified. Rather, your review is aimed at more accurately assessing the resources that the entity has to call upon. Any final ability to pay figure will clearly incorporate the judgment of the enforcement team regarding what is appropriate given the violation and original penalty amount.

While your extended ability to pay assessment can identify sources of funds for penalty payment, this might not happen in all cases. If extended analysis of an S corporation produces negative results, you might want to investigate the extent of shareholder liability. If you determine that shareholders could be responsible for corporate liabilities, you should perform a Beyond ABEL analysis on the individual shareholders to determine the amount of funds that they could contribute towards a penalty.

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[8] Assets: $240,600 - $7,600 = $233,000.
Liabilities: $155,650 - $5,000 = $150,650.
Equity: $233,000 - $150,650 = $82,350

CORPORATION

EXTENDED ABEL ANALYSIS

Section VII. Case Disposition (continued)

Equity Valuation

31. Adjusted company assets (subtract out liquidated assets)	
	+
32. Estimated excess value of undervalued assets	
	=
33. Adjusted total assets	
	-
34. Adjusted liabilities	
	=
35. Estimated adjusted equity (Line 33 - Line 34)	

Part C. Case Disposition

36. Violator's estimated after-tax cash flow for 19_____	$
37. Estimated assets available for liquidation	$
38. Estimated adjusted equity	$

Part D. Final Status (check one)

☐ Analysis completed

☐ Pursuing further analysis

nalyst's Name ______________________________ Date __________

CORPORATION

EXTENDED ABEL ANALYSIS

Section VI. Business Expenses

Part A. Officers' Salaries

Officer	Percent time devoted to business	Salary	Amount of reduction
17. Total reductions			

Summarize duties and provide justification for reductions listed above:

Part B. Other Expenses

Expenses category	Amount expended	Possible reduction
18. Total possible reduction in expenses		

Provide justification for reductions specified above:

CORPORATION

EXTENDED ABEL ANALYSIS

Section VII. Case Disposition

Part A. Cash Flow

19. Taxable income (before NOL) - Form 1120, line 28	
20. Depreciation/Depletion/Amortization	+
21. Pre-tax cash flow	=
22. Reductions in officer's salaries	+
23. Reductions in other expenses	+
24. Estimated pre-tax cash flow	=
25. Tax adjustment [(1 - 0.385) x Line 24]	=
26. Non-cash deduction tax benefits	+
27. Estimated after-tax cash flow (Line 25 + Line 26)	=

Part B. Equity Assessment

Asset Liquidation

28. Value of loans to shareholders	
29. Net value of luxury or unnecessary assets	+
30. Estimated funds available from liquidation	=

S-CORPORATION

EXTENDED ABEL ANALYSIS

Section VII. Case Disposition

Part A. Cash Flow

20. Taxable income - Form 1120S, line 21	
21. Depreciation/Depletion/Amortization	+
22. Pre-tax cash flow	=
23. Reductions in officer's salaries	+
24. Reductions in other expenses	+
25. Estimated pre-tax cash flow	=
26. Tax adjustment (Line 24 x 0.67)	=
27. Non-cash deduction tax benefits	+
28. Estimated after-tax cash flow (Line 26 + Line 27)	=

Part B. Equity Assessment

Asset Liquidation

29. Value of loans to shareholders	
30. Net value of luxury or unnecessary assets	+
31. Estimated funds available from liquidation	=

S-CORPORATION

EXTENDED ABEL ANALYSIS

Section VII. Case Disposition (continued)

Equity Valuation

32. Adjusted company assets (subtract out liquidated assets)	
33. Estimated excess value of undervalued assets	+
34. Adjusted total assets	=
35. Adjusted liabilities	-
36. Estimated adjusted equity (Line 34 - Line 35)	=

Part C. Case Disposition

37. Violator's estimated after-tax cash flow for 19_____	$
38. Estimated assets available for liquidation	$
39. Estimated adjusted equity	$

Part D. Final Status (check one)

☐ Analysis completed

☐ Pursuing further analysis

Analyst's Name ______________________________ Date ________

S-CORPORATION

EXTENDED ABEL ANALYSIS

Section IV. Business Assets (Use data from 1120S Schedule L, compare with Financial Statements)

Part A. Loans to Shareholders

Borrower	Date and amount of loan	Interest rate	Amount outstanding (date)
13. Total outstanding loans to shareholders			

Part B. Luxury Assets

Asset and use	Estimated market value	Balance due on loan	Replacement cost	Potentially available
14. Total potentially available net of replacement				

Section IV. Business Assets (continued)

Part C. Undervalued Assets

Asset and use	Book value	Estimated market value	Value difference
15. Total estimated excess value of assets			

S-CORPORATION

EXTENDED ABEL ANALYSIS

Section V. Loans from Shareholders

Lender	Date and amount of loan	Amount outstanding (date)
16. Total outstanding loans		
17. Revised liability total		

S-CORPORATION

EXTENDED ABEL ANALYSIS

Section VI. Business Expenses

Part A. Officers' Salaries

Officer	Salary	Amount of reduction
18. Total reductions		

Summarize duties and provide justification for reductions listed above:

Part B. Other Expenses

Expenses category	Amount expended	Possible reduction
19. Total possible reduction in expenses		

Provide justification for reductions specified above:

S-CORPORATION

EXTENDED ABEL ANALYSIS

Section III. Ownership and Operating Affiliations (from tax returns, Financial Statements and/or D&B report)

Part A. Corporate Affiliates

Additional business concerns (check and answer where applicable)	Yes	No
9. Is this S-corporation affiliated with any other business concerns		

10. If Yes, provide the following information:

Affiliate's Name	Type of entity	Relationship and percentage ownership

Part B. Shareholders and Officers

11. Shareholder and corporate position	Percent ownership	Dividends/ Distributions	Information regarding shareholder affiliations

S-CORPORATION

EXTENDED ABEL ANALYSIS

12. Summary: Discuss possible expansion of ability to pay analysis, and additional information required.

SUBCHAPTER S-CORPORATION

EXTENDED ABEL ANALYSIS

Section I. General Information

1. Violator's name:
2. Address:
3. Principal business activity and product or service (1120S Schedule B Lines 2a and 2b):

4. Original penalty amount	
5. As a percent of sales (penalty ÷ 1120S line 1a)	

Section II. Financial Information

6. Tax returns and schedules available	Year Prepared

7. Financial Statements provided	Audited? Y or N	Period(s) covered

SUBCHAPTER S-CORPORATION

EXTENDED ABEL ANALYSIS

Section II. Financial Information (continued)

8. Other violator or general industry information collected and date of document(s):

Form **1120-A**

Department of the Treasury
Internal Revenue Service

U.S. Corporation Short-Form Income Tax Return

Instructions are separate. See them to make sure you qualify to file Form 1120-A.

For calendar year 1991 or tax year beginning ...., 1991, ending ......, 19 ...

OMB No. 1545-0890

1991

A Check this box if corp. is a personal service corp. (as defined in Temp. Regs. sec. 1.441-4T—see instructions) ▶ ☐

Use IRS label. Otherwise, please print or type.

Name

Number, street, and room or suite no. (If a P.O. box, see page 6 of instructions.)

City or town, state, and ZIP code

B Employer identification number

C Date incorporated

D Total assets (see Specific Instructions)

$

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Change in address

F Check method of accounting: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

Income

1a	Gross receipts or sales ______ b Less returns and allowances ______ c Balance ▶	1c	
2	Cost of goods sold (see instructions)	2	
3	Gross profit. Subtract line 2 from line 1c	3	
4	Domestic corporation dividends subject to the 70% deduction	4	
5	Interest	5	
6	Gross rents	6	
7	Gross royalties	7	
8	Capital gain net income (attach Schedule D (Form 1120))	8	
9	Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797)	9	
10	Other income (see instructions)	10	
11	**Total income.** Add lines 3 through 10 ▶	11	

Deductions (See instructions for limitations on deductions.)

12	Compensation of officers (see instructions)			12	
13a	Salaries and wages ______ b Less jobs credit ______ c Balance ▶			13c	
14	Repairs			14	
15	Bad debts			15	
16	Rents			16	
17	Taxes			17	
18	Interest			18	
19	Contributions (**see instructions for 10% limitation**)			19	
20	Depreciation (attach Form 4562)	20			
21	Less depreciation claimed elsewhere on return	21a		21b	
22	Other deductions (attach schedule)			22	
23	**Total deductions.** Add lines 12 through 22 ▶			23	
24	Taxable income before net operating loss deduction and special deductions. Subtract line 23 from line 11			24	
25	**Less:** a Net operating loss deduction (see instructions)	25a			
	b Special deductions (see instructions)	25b		25c	

Tax and Payments

26	**Taxable income.** Subtract line 25c from line 24					26	
27	**Total tax** (from page 2, Part I, line 7)					27	
28	**Payments:**						
	a 1990 overpayment credited to 1991	28a					
	b 1991 estimated tax payments	28b					
	c Less 1991 refund applied for on Form 4466	28c		Bal ▶	28d		
	e Tax deposited with Form 7004				28e		
	f Credit from regulated investment companies (attach Form 2439)				28f		
	g Credit for Federal tax on fuels (attach Form 4136). See instructions				28g		
	h **Total payments.** Add lines 28d through 28g					28h	
29	Estimated tax penalty (see page 4 of instructions). Check if Form 2220 is attached ▶ ☐					29	
30	**Tax due.** If the total of lines 27 and 29 is larger than line 28h, enter amount owed					30	
31	**Overpayment.** If line 28h is larger than the total of lines 27 and 29, enter amount overpaid					31	
32	Enter amount of line 31 you want: **Credited to 1992 estimated tax ▶** ______ **Refunded ▶**					32	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer | Date | ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ▶ ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

Part I Tax Computation

1 Income tax (see instructions to figure the tax). Check this box if the corp. is a qualified personal service corp. (see instructions) ▶ ☐	1	
2a General business credit. Check if from: ☐ Form 3800 ☐ Form 3468 ☐ Form 5884 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586 ☐ Form 8830 ☐ Form 8826 — 2a		
b Credit for prior year minimum tax (attach Form 8827) — 2b		
3 **Total credits.** Add lines 2a and 2b	3	
4 Subtract line 3 from line 1	4	
5 Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611	5	
6 Alternative minimum tax (attach Form 4626). See instructions	6	
7 **Total tax.** Add lines 4 through 6. Enter here and on line 27, page 1	7	

Part II Other Information (See page 15 of the instructions.)

1 Refer to the list in the instructions and state the principal:
 a Business activity code no. ▶ ....
 b Business activity ▶ ....
 c Product or service ▶ ....

2 Did any individual, partnership, estate, or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) ☐ Yes ☐ No

If "Yes," attach schedule showing name, address, and identifying number

3 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $

4 Enter amount of cash distributions and the book value of property (other than cash) distributions made in this tax year ▶ $

5a If an amount is entered on line 2, page 1, see the worksheet on page 11 for amounts to enter below:
 (1) Purchases (see instructions)
 (2) Additional sec. 263A costs (see instructions—attach schedule)
 (3) Other costs (attach schedule)

b Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☐ Yes ☐ No

6 At any time during the tax year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 15 of the instructions for filing requirements for Form TD F 90-22.1.) ☐ Yes ☐ No

If "Yes," enter the name of the foreign country ▶ ....

Part III Balance Sheets

		(a) Beginning of tax year	(b) End of tax year
Assets	1 Cash		
	2a Trade notes and accounts receivable		
	b Less allowance for bad debts	( )	( )
	3 Inventories		
	4 U.S. government obligations		
	5 Tax-exempt securities (see instructions)		
	6 Other current assets (attach schedule)		
	7 Loans to stockholders		
	8 Mortgage and real estate loans		
	9a Depreciable, depletable, and intangible assets		
	b Less accumulated depreciation, depletion, and amortization	( )	( )
	10 Land (net of any amortization)		
	11 Other assets (attach schedule)		
	12 Total assets		
Liabilities and Stockholders' Equity	13 Accounts payable		
	14 Other current liabilities (attach schedule)		
	15 Loans from stockholders		
	16 Mortgages, notes, bonds payable		
	17 Other liabilities (attach schedule)		
	18 Capital stock (preferred and common stock)		
	19 Paid-in or capital surplus		
	20 Retained earnings		
	21 Less cost of treasury stock	( )	( )
	22 Total liabilities and stockholders' equity		

Part IV Reconciliation of Income per Books With Income per Return (Must be completed by all filers.)

1 Net income per books		6 Income recorded on books this year not included on this return (itemize)	
2 Federal income tax			
3 Excess of capital losses over capital gains		7 Deductions on this return not charged against book income this year (itemize)	
4 Income subject to tax not recorded on books this year (itemize)			
5 Expenses recorded on books this year not deducted on this return (itemize)		8 Income (line 24, page 1). Enter the sum of lines 1 through 5 less the sum of lines 6 and 7	

★U.S. GPO: 1991 O-285-248

Schedule J Tax Computation

1 Check if you are a member of a controlled group (see sections 1561 and 1563) ▶ ☐

2 If the box on line 1 is checked

a Enter your share of the $50,000 and $25,000 taxable income bracket amounts (in that order)
(i) $ ______ (ii) $ ______

b Enter your share of the additional 5% tax (not to exceed $11,750) ▶ $ ______

3 Income tax (see instructions to figure the tax) Check this box if the corporation is a qualified personal service corporation (see instructions on page 13) ▶ ☐ | 3

4a Foreign tax credit (attach Form 1118) | 4a

b Possessions tax credit (attach Form 5735) | 4b

c Orphan drug credit (attach Form 6765) | 4c

d Credit for fuel produced from a nonconventional source (see instructions) | 4d

e General business credit. Enter here and check which forms are attached
☐ Form 3800 ☐ Form 3468 ☐ Form 5884 ☐ Form 6478
☐ Form 6765 ☐ Form 8586 ☐ Form 8830 ☐ Form 8826 | 4e

f Credit for prior year minimum tax (attach Form 8827) | 4f

5 **Total.** Add lines 4a through 4f | 5

6 Subtract line 5 from line 3 | 6

7 Personal holding company tax (attach Schedule PH (Form 1120)) | 7

8 Recapture taxes Check if from ☐ Form 4255 ☐ Form 8611 | 8

9a Alternative minimum tax (attach Form 4626) See instructions | 9a

b Environmental tax (attach Form 4626) | 9b

10 ***Total tax.*** Add lines 6 through 9b Enter here and on line 31 page 1 | 10

Schedule K Other Information (See page 15 of the instructions.)

	Yes	No
1 Check method of accounting a ☐ Cash b ☐ Accrual c ☐ Other (specify) ▶		
2 Refer to the list in the instructions and state the principal a Business activity code no ▶ .... b Business activity ▶ .... c Product or service ▶		
3 Did the corporation at the end of the tax year own directly or indirectly 50% or more of the voting stock of a domestic corporation? (For rules of attribution see section 267(c).) If "Yes" attach a schedule showing (a) name address and identifying number (b) percentage owned and (c) taxable income or (loss) before NOL and special deductions of such corporation for the tax year ending with or within your tax year		
4 Did any individual partnership corporation estate or trust at the end of the tax year own directly or indirectly 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) If "Yes" complete a and b a Attach a schedule showing name address, and identifying number b Enter percentage owned ▶		
5 Did one foreign person (see instructions for definition) at any time during the tax year own at least 25% of a The total voting power of all classes of stock of the corporation entitled to vote, or b The total value of all classes of stock of the corporation? If "Yes" the corporation may have to file Form 5472 If "Yes, enter owner's country(ies) ▶ .... Enter number of Forms 5472 attached ▶		
6 Was the corporation a U.S shareholder of any controlled foreign corporation? (See sections 951 and 957.) If "Yes," attach Form 5471 for each such corporation Enter number of Forms 5471 attached ▶		
7 At any time during the tax year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 15 of the instructions for more information including filing requirements for Form TD F 90-22.1.) If "Yes" enter name of foreign country ▶		
8 Was the corporation the grantor of, or transferor to, a foreign trust that existed during the current tax year whether or not the corporation has any beneficial interest in it? If "Yes" the corporation may have to file Forms 3520, 3520-A, or 926		
9 During this tax year did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) If "Yes," file Form 5452 If this is a consolidated return answer here for parent corporation and on **Form 851**, Affiliations Schedule, for each subsidiary.		
10 Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If so, the corporation may have to file Form 8281		
11 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ ______		
12 If there were 35 or fewer shareholders at the end of the tax year enter the number ▶		

Schedule L Balance Sheets

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash				
2a Trade notes and accounts receivable				
b Less allowance for bad debts	( )		( )	
3 Inventories				
4 U S government obligations				
5 Tax-exempt securities (see instructions)				
6 Other current assets (attach schedule)				
7 Loans to stockholders				
8 Mortgage and real estate loans				
9 Other investments (attach schedule)				
10a Buildings and other depreciable assets				
b Less accumulated depreciation	( )		( )	
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach schedule)				
15 Total assets				
Liabilities and Stockholders' Equity				
16 Accounts payable				
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach schedule)				
19 Loans from stockholders				
20 Mortgages, notes, bonds payable in 1 year or more				
21 Other liabilities (attach schedule)				
22 Capital stock a Preferred stock				
b Common stock				
23 Paid-in or capital surplus				
24 Retained earnings—Appropriated (attach schedule)				
25 Retained earnings—Unappropriated				
26 Less cost of treasury stock		( )		( )
27 Total liabilities and stockholders' equity				

Schedule M-1 Reconciliation of Income per Books With Income per Return *(This schedule does not have to be completed if the total assets on line 15, column (d), of Schedule L are less than $25,000.)*

1 Net income per books

2 Federal income tax

3 Excess of capital losses over capital gains

4 Income subject to tax not recorded on books this year (itemize) ....

5 Expenses recorded on books this year not deducted on this return (itemize)

a Depreciation $ ....

b Contributions carryover $ ....

c Travel and entertainment $ ....

6 Add lines 1 through 5

7 Income recorded on books this year not included on this return (itemize)

a Tax-exempt interest $ ....

8 Deductions on this return not charged against book income this year (itemize)

a Depreciation $ ....

b Contributions carryover $ ....

9 Add lines 7 and 8

10 Income (line 28, page 1)—line 6 less line 9

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L) *(This schedule does not have to be completed if the total assets on line 15, column (d), of Schedule L are less than $25,000.)*

1 Balance at beginning of year

2 Net income per books

3 Other increases (itemize) ....

4 Add lines 1, 2, and 3

5 Distributions: a Cash

b Stock

c Property

6 Other decreases (itemize) ....

7 Add lines 5 and 6

8 Balance at end of year (line 4 less line 7)

Schedule L Balance Sheets

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash				
2a Trade notes and accounts receivable				
b Less allowance for bad debts				
3 Inventories				
4 U S Government obligations				
5 Tax-exempt securities				
6 Other current assets *(attach schedule)*				
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments *(attach schedule)*				
10a Buildings and other depreciable assets				
b Less accumulated depreciation				
11a Depletable assets				
b Less accumulated depletion				
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization				
14 Other assets *(attach schedule)*				
15 Total assets				
Liabilities and Shareholders' Equity				
16 Accounts payable				
17 Mortgages notes bonds payable in less than 1 year				
18 Other current liabilities *(attach schedule)*				
19 Loans from shareholders				
20 Mortgages notes bonds payable in 1 year or more				
21 Other liabilities *(attach schedule)*				
22 Capital stock				
23 Paid-in or capital surplus				
24 Retained earnings				
25 Less cost of treasury stock		( )		( )
26 Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income per Books With Income per Return (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income per books		5 Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize):	
2 Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize):		a Tax-exempt interest $	
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15e, and 16a (itemize):		6 Deductions included on Schedule K, lines 1 through 11a, 15e, and 16a, not charged against book income this year (itemize):	
a Depreciation $		a Depreciation $	
b Travel and entertainment $			
		7 Add lines 5 and 6	
4 Add lines 1 through 3		8 Income (loss) (Schedule K, line 20). Line 4 less line 7	

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (See instructions.)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year			
2 Ordinary income from page 1, line 21			
3 Other additions			
4 Loss from page 1, line 21	( )		
5 Other reductions	( )	( )	
6 Combine lines 1 through 5			
7 Distributions other than dividend distributions			
8 Balance at end of tax year. Subtract line 7 from line 6			

Schedule K Shareholders' Shares of Income, Credits, Deductions, etc.

		(a) Pro rata share items		(b) Total amount
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 21)	1	
	2	Net income (loss) from rental real estate activities *(attach Form 8825)*	2	
	3a	Gross income from other rental activities — 3a		
	b	Less expenses *(attach schedule)* — 3b		
	c	Net income (loss) from other rental activities	3c	
	4	Portfolio income (loss):		
	a	Interest income	4a	
	b	Dividend income	4b	
	c	Royalty income	4c	
	d	Net short-term capital gain (loss) *(attach Schedule D (Form 1120S))*	4d	
	e	Net long-term capital gain (loss) *(attach Schedule D (Form 1120S))*	4e	
	f	Other portfolio income (loss) *(attach schedule)*	4f	
	5	Net gain (loss) under section 1231 (other than due to casualty or theft) *(attach Form 4797)*	5	
	6	Other income (loss) *(attach schedule)*	6	
Deductions	7	Charitable contributions (see instructions) *(attach list)*	7	
	8	Section 179 expense deduction *(attach Form 4562)*	8	
	9	Deductions related to portfolio income (loss) (see instructions) (itemize)	9	
	10	Other deductions *(attach schedule)*	10	
Investment Interest	11a	Interest expense on investment debts	11a	
	b (1)	Investment income included on lines 4a through 4f above	11b(1)	
	(2)	Investment expenses included on line 9 above	11b(2)	
Credits	12a	Credit for alcohol used as a fuel *(attach Form 6478)*	12a	
	b	Low-income housing credit (see instructions):		
	(1)	From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12b(1)	
	(2)	Other than on line 12b(1) for property placed in service before 1990	12b(2)	
	(3)	From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12b(3)	
	(4)	Other than on line 12b(3) for property placed in service after 1989	12b(4)	
	c	Qualified rehabilitation expenditures related to rental real estate activities *(attach Form 3468)*	12c	
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities (see instructions)	12d	
	e	Credits related to other rental activities (see instructions)	12e	
	13	Other credits (see instructions)	13	
Adjustments and Tax Preference Items	14a	Accelerated depreciation of real property placed in service before 1987	14a	
	b	Accelerated depreciation of leased personal property placed in service before 1987	14b	
	c	Depreciation adjustment on property placed in service after 1986	14c	
	d	Depletion (other than oil and gas)	14d	
	e (1)	Gross income from oil, gas, or geothermal properties	14e(1)	
	(2)	Deductions allocable to oil, gas, or geothermal properties	14e(2)	
	f	Other adjustments and tax preference items *(attach schedule)*	14f	
Foreign Taxes	15a	Type of income ▶		
	b	Name of foreign country or U.S. possession ▶		
	c	Total gross income from sources outside the United States *(attach schedule)*	15c	
	d	Total applicable deductions and losses *(attach schedule)*	15d	
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	15e	
	f	Reduction in taxes available for credit *(attach schedule)*	15f	
	g	Other foreign tax information *(attach schedule)*	15g	
Other	16a	Total expenditures to which a section 59(e) election may apply	16a	
	b	Type of expenditures ▶		
	17	Total property distributions (including cash) other than dividends reported on line 19 below	17	
	18	Other items and amounts required to be reported separately to shareholders (see instructions) *(attach schedule)*		
	19	Total dividend distributions paid from accumulated earnings and profits	19	
	20	**Income (loss)** (Required only if Schedule M-1 must be completed.). Combine lines 1 through 6 in column (b). From the result, subtract the sum of lines 7 through 11a, 15e, and 16a	20	

Form **1120**

Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1991 or tax year beginning ...., 1991, ending ...., 19

▶ **Instructions are separate. See page 1 for Paperwork Reduction Act Notice.**

OMB No. 1545-0123

1991

A Check if a—
1) Consolidated return (attach Form 851) ☐
2) Personal holding co. (attach Sch. PH) ☐
3) Personal service corp. (as defined in Temp. Regs. sec. 1.441-4T—see instructions) ☐

Use IRS label. Otherwise, please print or type.

Name

Number, street, and room or suite no. (If a P.O. box, see page 6 of instructions.)

City or town, state, and ZIP code

B Employer identification number

C Date incorporated

D Total assets (see Specific Instructions)

$

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address

Income

1a	Gross receipts or sales ______ b Less returns and allowances ______ c Bal ▶	1c	
2	Cost of goods sold (Schedule A, line 7)	2	
3	Gross profit. Subtract line 2 from line 1c	3	
4	Dividends (Schedule C, line 19)	4	
5	Interest	5	
6	Gross rents	6	
7	Gross royalties	7	
8	Capital gain net income (attach Schedule D (Form 1120))	8	
9	Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797)	9	
10	Other income (see instructions—attach schedule)	10	
11	**Total income.** Add lines 3 through 10 ▶	11	

Deductions (See instructions for limitations on deductions.)

12	Compensation of officers (Schedule E, line 4)	12	
13a	Salaries and wages ______ b Less jobs credit ______ c Balance ▶	13c	
14	Repairs	14	
15	Bad debts	15	
16	Rents	16	
17	Taxes	17	
18	Interest	18	
19	Contributions (**see instructions for 10% limitation.**)	19	
20	Depreciation (attach Form 4562) 20 ______		
21	Less depreciation claimed on Schedule A and elsewhere on return 21a ______	21b	
22	Depletion	22	
23	Advertising	23	
24	Pension, profit-sharing, etc., plans	24	
25	Employee benefit programs	25	
26	Other deductions (attach schedule)	26	
27	**Total deductions.** Add lines 12 through 26 ▶	27	
28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28	
29	**Less:** a Net operating loss deduction (see instructions) 29a ______		
	b Special deductions (Schedule C, line 20) 29b ______	29c	

Tax and Payments

30	**Taxable income.** Subtract line 29c from line 28	30	
31	**Total tax** (Schedule J, line 10)	31	
32	**Payments:** a 1990 overpayment credited to 1991 32a ______		
b	1991 estimated tax payments 32b ______		
c	Less 1991 refund applied for on Form 4466 32c ______ d Bal ▶ 32d ______		
e	Tax deposited with Form 7004 32e ______		
f	Credit from regulated investment companies (attach Form 2439) 32f ______		
g	Credit for Federal tax on fuels (attach Form 4136). See instructions 32g ______	32h	
33	Estimated tax penalty (see page 4 of instructions). Check if Form 2220 is attached ▶ ☐	33	
34	**Tax due.** If the total of lines 31 and 33 is larger than line 32h, enter amount owed	34	
35	**Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid	35	
36	Enter amount of line 35 you want: **Credited to 1992 estimated tax** ▶ ______ **Refunded** ▶	36	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer ______ Date ______ ▶ Title ______

Paid Preparer's Use Only

Preparer's signature ▶ ______ Date ______ Check if self-employed ☐ Preparer's social security number ______

Firm's name (or yours if self-employed) and address ▶ ______ E.I. No. ▶ ______ ZIP code ▶ ______

Schedule A Cost of Goods Sold (See instructions.)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4a	Additional section 263A costs (see instructions—attach schedule)	4a	
b	Other costs (attach schedule)	4b	
5	**Total.** Add lines 1 through 4b	5	
6	Inventory at end of year	6	
7	**Cost of goods sold.** Subtract line 6 from line 5. Enter here and on line 2, page 1	7	

8a Check all methods used for valuing closing inventory:
(i) ☐ Cost (ii) ☐ Lower of cost or market as described in Regulations section 1.471-4 (see instructions)
(iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c) (see instructions)
(iv) ☐ Other (Specify method used and attach explanation.) ▶ ....

b Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

c If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO | 8c |

d Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☐ Yes ☐ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☐ No

Schedule C Dividends and Special Deductions (See instructions.)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations that are subject to the 70% deduction (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations that are subject to the 80% deduction (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations (section 246A)		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		41.176	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		47.059	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs that are subject to the 70% deduction		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs that are subject to the 80% deduction		80	
8	Dividends from wholly owned foreign subsidiaries subject to the 100% deduction (section 245(b))		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from certain FSCs that are subject to the 100% deduction (section 245(c)(1))		100	
12	Dividends from affiliated group members subject to the 100% deduction (section 243(a)(3))		100	
13	Other dividends from foreign corporations not included on lines 3, 6, 7, 8, or 11			
14	Income from controlled foreign corporations under subpart F (attach Forms 5471)			
15	Foreign dividend gross-up (section 78)			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3 (section 246(d))			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities (see instructions)			
19	**Total dividends.** Add lines 1 through 17. Enter here and on line 4, page 1 ▶			
20	**Total deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on line 29b, page 1 ▶			

Schedule E Compensation of Officers (See instructions for line 12, page 1.)

Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 of page 1, Form 1120) are $500,000 or more.

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned: (d) Common	(e) Preferred	(f) Amount of compensation
1			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	

2	Total compensation of officers	
3	**Less:** Compensation of officers claimed on Schedule A and elsewhere on return	
4	Compensation of officers deducted on line 12, page 1	

SCHEDULE K-1 (Form 1120S)

Department of the Treasury
Internal Revenue Service

Shareholder's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1991 or tax year beginning , 1991, and ending , 19

OMB No. 1545-0130

1991

Shareholder's identifying number ▶ Corporation's identifying number ▶

Shareholder's name, address, and ZIP code

Corporation's name, address, and ZIP code

A Shareholder's percentage of stock ownership for tax year (see Instructions for Schedule K-1) ▶ .... %

B Internal Revenue service center where corporation filed its return ▶ ....

C (1) Tax shelter registration number (see Instructions for Schedule K-1) ▶ ....

(2) Type of tax shelter ▶ ....

D Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

		(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
Income (Loss)	1	Ordinary income (loss) from trade or business activities	1		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	2	Net income (loss) from rental real estate activities	2		
	3	Net income (loss) from other rental activities	3		
	4	Portfolio income (loss)			
	a	Interest	4a		Sch. B, Part I, line 1
	b	Dividends	4b		Sch. B, Part II, line 5
	c	Royalties	4c		Sch. E, Part I, line 4
	d	Net short-term capital gain (loss)	4d		Sch D, line 4, col (f) or (g)
	e	Net long-term capital gain (loss)	4e		Sch D, line 11, col (f) or (g)
	f	Other portfolio income (loss) *(attach schedule)*	4f		(Enter on applicable line of your return)
	5	Net gain (loss) under section 1231 (other than due to casualty or theft)	5		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	6	Other income (loss) *(attach schedule)*	6		(Enter on applicable line of your return)
Deductions	7	Charitable contributions (see instructions) *(attach schedule)*	7		Sch. A, line 13 or 14
	8	Section 179 expense deduction	8		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	9	Deductions related to portfolio income (loss) *(attach schedule)*	9		
	10	Other deductions *(attach schedule)*	10		
Investment Interest	11a	Interest expense on investment debts	11a		Form 4952, line 1
	b	(1) Investment income included on lines 4a through 4f above	b(1)		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
		(2) Investment expenses included on line 9 above	b(2)		
Credits	12a	Credit for alcohol used as fuel	12a		Form 6478, line 10
	b	Low-income housing credit:			
		(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
		(2) Other than on line 12b(1) for property placed in service before 1990	b(2)		
		(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
		(4) Other than on line 12b(3) for property placed in service after 1989	b(4)		
	c	Qualified rehabilitation expenditures related to rental real estate activities (see instructions)	12c		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities (see instructions)	12d		
	e	Credits related to other rental activities (see instructions)	12e		
	13	Other credits (see instructions)	13		
Adjustments and Tax Preference Items	14a	Accelerated depreciation of real property placed in service before 1987	14a		See Shareholder's Instructions for Schedule K-1 (Form 1120S) and Instructions for Form 6251
	b	Accelerated depreciation of leased personal property placed in service before 1987	14b		
	c	Depreciation adjustment on property placed in service after 1986	14c		
	d	Depletion (other than oil and gas)	14d		
	e	(1) Gross income from oil, gas, or geothermal properties	e(1)		
		(2) Deductions allocable to oil, gas, or geothermal properties	e(2)		
	f	Other adjustments and tax preference items *(attach schedule)*	14f		

		(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on
Foreign Taxes	15a	Type of income ▶			Form 1116, Check boxes
	b	Name of foreign country or U.S. possession ▶			Form 1116.
	c	Total gross income from sources outside the U.S. *(attach schedule)*	15c		Form 1116.
	d	Total applicable deductions and losses *(attach schedule)*	15d		Form 1116.
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	15e		Form 1116, Part II
	f	Reduction in taxes available for credit *(attach schedule)*	15f		Form 1116, Part III
	g	Other foreign tax information *(attach schedule)*	15g		See Instructions for Form 1116
Other	16a	Total expenditures to which a section 59(e) election may apply	16a		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	b	Type of expenditures ▶			See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	17	Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	17		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	18	Amount of loan repayments for "Loans From Shareholders"	18		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	19	Recapture of low-income housing credit:			
	a	From section 42(j)(5) partnerships	19a		Form 8611, line 8
	b	Other than on line 19a	19b		Form 8611, line 8

Supplemental Information

20 Supplemental information required to be reported separately to each shareholder *(attach additional schedules if more space is needed)*:

INTRODUCTION

A partnership is a business entity owned by individuals, other partnerships, or other businesses. Partnerships are not subject to federal income tax; rather, the income from the partnership is passed on to the partners, who individually pay taxes on their portion. In fact, many business organizations that opt to form as a partnership (or sole proprietorship) do so to avoid double taxation (i.e., paying taxes on both the business income and the income passed on to the owners). Although the partnership itself does not pay taxes, the partnership must submit a Federal Income Tax Form 1065 return detailing the entity's income and expenses, its partners, and the share of income passed on to each partner. The Form 1065 return should include a Schedule K-1 for each partner, specifying the share of income the partner received, and a Schedule of Activities for that partner.[1]

There are two types of partnerships: general and limited. A general partnership member is not limited in its liability (that is, its responsibility) for company debts. All general partners, regardless of their investment or activity in the company, have total liability. Therefore, an ability to pay analysis of a general partnership should extend beyond the company to the financial position of the general partners themselves.

[1] See the Federal Income Tax Return form 1065 sample at the end of this chapter. Note that partnerships responding "Yes" to Item N on page 1 of the Form 1065 are not required to complete Schedules L and M, Item F on page 1 of the 1065, or Item K on Schedule K-1. Consult the Instruction booklet for Form 1065 for a description of partnerships not subject to this reporting.

A limited partnership is usually comprised of both general and limited partners. General partners have unlimited liability, while limited partners are responsible only up to the amount of their contributed capital. An investigation of a limited partnership's ability to pay would consider both the resources of the partnership and the resources of the general partner(s).[2]

Because general partners are personally liable for the financial responsibilities of the firm they sometimes own only a small percentage of the business. Liabilities or penalties can then sometimes be absorbed almost entirely by the limited partners. For example, let's say that three individuals form a partnership -- the two limited partners each contribute $25,000 in capital, and each holds 49 percent of the partnership, while the general partner holds two percent. The general partner runs the business and is paid a salary; the limited partners receive income based on the earnings of the business. Assume that the business fails and the partners are liable for its debts, which total $40,000. Each of the limited partners would be responsible for 49 percent of this amount ($19,600 each), while the general partner would only be responsible for two percent ($800).

If, however, liabilities are larger than total contributed capital in the partners' accounts, the general partner is required to produce funds from his or her personal resources. For example, if total liabilities equal $100,000, each limited partner is responsible to the extent of his or her total investment in the firm ($25,000 each), and the general partner is liable for the remaining $50,000, even though this amount exceeds his or her capital contribution to the partnership.

Before proceeding with the rest of this chapter, be certain to read Chapter 2, as it contains important information about the worksheets.

Section I - General Information

The first section of the worksheet summarizes basic information about the violator (in this case, the partnership) and information that has been collected thus far:

- **Violator's name.** On Line 1, enter the name of the partnership.

- **Address.** On Line 2, enter the violator's address.

[2] Many of the partnership ability to pay cases may involve real estate or land development concerns. On a financial statement, real estate investments often appear to be losing money, because non-cash expenses, such as depreciation and amortization, can be deducted from the property's revenues. In the early stages of such a concern, revenues may be minimal and the partnership will report a loss. These "paper" losses are then passed on to the partners, reducing their taxable income. Ultimately the partners often recognize financial gains through the sale of the property. However, because a real estate partnership might not generate cash flow (unless property is sold) an ABEL analysis will often indicate that the entity is unable to pay. Therefore, in conducting an ability to pay assessment for real estate partnerships, you must pay particular attention to the difference between book and market values for property, and to any non-cash expenditures. We will highlight these factors on the partnership worksheets.

- **Type of partnership.** On Line 3, check whether this is a limited or general partnership.

- **Principal business activity and product or service.** On Line 4, enter the violator's principal business activity, along with its product or service.[3] This information can be found on the Partnership Income Tax return Form 1065, Items A and B of the first page.[4]

- **Original penalty amount.** Note on Line 5 the original penalty amount proposed.

- **Penalty as a percent of income.** Divide the original penalty amount by the entity's total income (Line 8 on page 1 of Form 1065). Note the result on Line 6.

<u>Section II - Financial Information</u>

In this section of the worksheet we summarize the financial information available.

- **Tax forms and schedules available.** On Line 7, enter the tax forms and schedules supplied, along with the year of the return. Note also whether any tax information is missing.

- **Financial Statements provided.** On Line 8, list each available financial statement (e.g., Balance Sheets, Income Statements and notes). Is this an audited statement? Note the period covered by the statement, particularly if the statement covers only a portion of the fiscal year. Also note whether any necessary or useful information is missing.

- **Other violator or general industry information collected.** On Line 9, list any other material you have obtained and/or researched. Examples include the partnership agreement, Dun & Bradstreet reports, a company prospectus, loan applications, etc. Note as well the period covered by the document.

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[3] You may want to consult a financial analyst if the partnership is an agricultural operation, as these businesses can be difficult to analyze.

[4] Throughout these worksheets, we reference Line items on the 1991 version of Form 1065. The location of items may differ for previous years' forms.

Section III - Ownership and Operating Affiliations

Part A - Partner Information

This section of the worksheet asks for detailed information on each of the partners, as well as information about whether the violator itself is a partner in another partnership. This information is particularly important, as it will indicate the extent to which the ability to pay analysis will extend beyond the violator itself. Complete the following information for each of the general partners.[5]

- **General partner.** Enter the name of the general partner.
- **Type of entity.** Note whether this partner is an individual, partnership, or corporation.
- **Percent ownership.** Schedule K-1, Item F specifies the partner's share in the business.
- **Guaranteed payments to partner.** Line 10 of the Form 1065 and Line 5 of each partner's K-1 note guaranteed payments. These payments are for services (e.g., if a partner earns a salary) or for the use of capital. Note on the worksheet whether the partner has received any guaranteed payments.

Part B - Other Partnerships

Here we investigate whether the violator is a partner in any other partnerships. This information is provided on Form 1065, Schedule B, Question 3.

- **Is the violator a partner in any other partnerships?** Check yes or no.
- **Name of partnership.** Note here the name of the partnership in which the violator is a partner.
- **Principal business activity.** If available, note here information about this partnership's business activities and/or products.
- **Information required for further analysis.** A detailed analysis of this partnership may be required in the event that the violator is unable to produce funds for a penalty. Note here the information that would be required to investigate this related partnership.

[5] Copy this page of the worksheet if additional information blocks are needed.

Section IV - Business Assets

In this section of the worksheet, we review the partnership's assets and investigate their use and worth. Our aim is to discover whether the company is holding luxury or unnecessary assets, or is undervaluing its assets and thereby understating its equity. As stated in Chapter 2, luxury assets might include luxury or unnecessary vehicles, boats, planes, rental property, or other assets not necessary to the company's operations.

This review will focus on the partnership's more valuable assets, generally those valued at more than $5,000. Request that the partnership provide a list specifying both the book and the market value of these assets, as well as their business use. The latter information is important for determining whether each asset is essential to company operations. Review the list that you receive carefully. Do the market values seem reasonable? The worth of valuable assets should be double checked against outside sources. Vehicle values are published in industry "blue books," available at car dealerships. Industry analysts or associations can often estimate the value of business or industrial equipment. County or local property assessors should be able to verify the value of land and/or buildings in their jurisdiction. It will be particularly important to seek out this information if you are analyzing a real estate or land development partnership.

Once you have reviewed this information, you can complete the Luxury Assets and Undervalued Assets portions of this worksheet section.

Part A - Luxury Assets

Provide the following information for each of the partnership's luxury assets.

- **Asset and use.** Describe the asset (for example, note make and year of luxury vehicles, location of rental property or buildings) and its use. In this section you may also want to explain why you consider this asset to be a "luxury" for the partnership.

- **Estimated market value.** Note the market value of the asset and the source for this information.

- **Balance due on loan.** Note here any remaining loans outstanding on this asset.

- **Replacement cost.** Estimate the cost of substituting luxury assets that are being used by the company with less expensive replacements. For example, company officers may need vehicles to conduct business, but they don't necessarily need luxury vehicles.

- **Potentially available.** To estimate funds potentially available for this asset, subtract the outstanding loan amount from its market value.

- **Total potentially available net of replacement.** Add the potentially available value of all the luxury assets you've investigated and note on Line 10.

Part B - Undervalued Assets

his section, note on the worksheet any discrepancies between the book value of an asset and its . arket value.

- **Asset and use.** Describe the asset and its use in the business.

- **Book value.** Note the value as stated on the company's financial statements or tax return (Schedule L "Balance Sheet" on Form 1065).

- **Estimated market value.** Note the market value of the asset and the source for this information.

- **Total estimated excess value of assets.** Sum the difference between estimated market value and book value of all undervalued assets and enter the amount on Line 11.

Section V - Business Expenses

In this section of the worksheet we review the partnership's expenses, evaluating their level and necessity. Partnership expenses are listed as deductions on Form 1065, Items 9a through 20. Be certain to examine any attached statements that detail expenses under Item 20 "Other deductions."

In your review of partnership expenses, pay particular attention to travel and entertainment or subsistence expenses, vehicle expenses, and office expenses and supplies. Such expenses may mask funds going to partners or employees (for example, vehicle expenses might also include personal use of vehicles). Also examine closely any expenses paid to related parties (e.g., partners), such as expenses for professional services or subcontractors.

- **Expense category.** Review the partnership's expenses and list those that you believe can be reduced without materially affecting the operations of the company.

- **Amount expended.** Note the annual amount for each expense that you believe can be reduced.

- **Possible reduction.** Enter the reduction that you think is reasonable.

- **Total possible reduction in expenses.** On Line 12, sum all possible reductions in expenses.

- **Justification for reduction.** Describe here your reasons for any possible reductions.

Section VI - Case Disposition

In this section of the worksheet we summarize our findings and reassess the violator's ability to pay. This analysis has two steps: (1) a cash flow calculation, and (2) an equity assessment. For a partnership, equity in the company will be reflected in the partners' capital accounts (Form 1065, Schedule M-2, Line 9). These accounts measure the net worth of the partnership (assets less liabilities).

Part A - Cash Flow

As explained in Chapter 2, our manual cash flow calculation is simply adjusted net income less adjusted expenses. This figure is computed as follows:

- **Total partnership income.** On Line 13, enter pre-tax income to the partnership as reported on Form 1065, Item 8.
- **Depreciation, depletion and amortization expenses.** In Chapter 2 we explain that these are non-cash expenses that do not affect a company's cash flow. We therefore add these expenses back into the partnership's income. Sum the amounts claimed on Form 1065, Lines 16a and 17 and enter the sum on Line 14.
- **Total pre-tax cash flow.** On Line 15, sum the amounts on Lines 13 and 14. This amount represents the partnership's pre-tax cash flow.
- **Reductions in expenses.** On Line 16, enter the total from Line 12 in Section VI, Part B of this worksheet.
- **Estimated pre-tax cash flow.** Add the amounts on Lines 15 through 16 to estimate potential partnership pre-tax income on Line 17.
- **Tax adjustment.** Multiply this amount by one minus the highest income tax rate for individuals (1 - 0.33 = 0.67) and enter the result on Line 18.[6]
- **Non-cash deduction tax benefits.** Multiply the amount in Line 14 by the tax rate (0.67), and enter the result on Line 19.
- **Estimated after-tax cash flow.** Add together Lines 18 and 19. This amount represents an estimate of what the partnership might be able to produce in after-tax cash flow in the coming year, if income remains steady and expenses are reduced.

[6] We use the individual income tax rate because partnership income is passed on to the partners.

As an example, let's assume that Partners in Land Development (PLD -- a fictitious partnership) declared a net loss of $465,392 in the year you are analyzing.[7] We add back to this figure depreciation, amortization and depletion expenses, as they are not cash expenses for the partnership and do not increase the company's annual cash outflows. PLD claimed $17,685 in depreciation for the year. Adding back this amount gives us a net loss of $446,506.

Suppose your investigation has shown that the partners in the firm are not receiving any income from PLD's activities; in fact, they are claiming a loss on their individual Schedules K-1. You believe, however, that the partnership can feasibly reduce other expenses by about $2,000 per year. This amount decreases PLD's net loss to -$464,192. Adjusting this figure for taxes yields a loss of -$311,009 (-$464,192 x 0.67).

Next, add back the tax benefit of PLD's non-cash deductions. Multiply PLD's depreciation expense by the tax rate ($17,685 x 0.33) and reduce the loss by the result ($5,836). PLD's estimated after-tax cash flow is thus -$305,173 (-$311,009 - $5,836). In other words, on an after-tax basis, PLD has negative cash flow. We cannot look to cash flow as a source of penalty funds.

Part B - Equity Assessment (Partners' Capital Accounts)

In assessing PLD's equity we want to determine: (1) the value of assets that could be liquidated to provide penalty funds, and (2) the true equity of the partnership, based on the value of its remaining assets.

To begin, enter the amount from Line 10 in Section IV, Part B on Line 21 of this worksheet. This amount summarizes your earlier review of all assets, and lists the net value of those that can be liquidated, net of replacement costs for less expensive, substitute assets. Next, we summarize equity information gathered on the partnership's remaining assets and liabilities. To calculate the value of these assets, follow the steps below:

- **Adjusted partnership assets.** On Line 22, enter the adjusted value of partnership assets. To calculated this figure, subtract liquidated assets from assets as they appear on Form 1065, Schedule L, Item 14(d).

- **Estimated excess value of undervalued assets.** On Line 23, enter the total on Line 11 of Section IV, Part B of this worksheet.

- **Adjusted value of assets.** Sum Lines 22 and 23 and enter the total on Line 24. This figure represents the adjusted value of the partnership's equity.

- **Estimated adjusted equity.** Subtract partnership liabilities from Line 22 above. This result is an estimate of partnership equity.

[7] Recall that it is common for real estate concerns to have negative income (i.e., a loss).

Assume that during your investigation you discovered that PLD owns only one significant asset -- a piece of land with a stated value of approximately $9 million. Your investigation into the property's market value indicates that this figure does not need adjusting. The partnership's remaining mortgage on this land equals about $2.5 million. Therefore, the net value of this land to the partners is approximately $6.5 million before taxes.

Suppose that you learn that the partnership plans to develop this land for both commercial and residential use; and, further, that similar projects have earned their owners very large returns. Using this information, you could argue that the PLD Partnership could produce penalty funds by selling its land. In this case, enforcement staff would have to consider the penalty and circumstances carefully, since selling the land would certainly affect the partnership's material position. Alternatively, the partners could borrow approximately $3.8 to $4.7 million (with the real estate as collateral and using conservative financing assumptions) to produce funds for the penalty.[8]

Part C - Case Disposition

In the example above we determined that, although the violator had negative cash flow, equity in the partnership was such that the violator had the potential to generate penalty funds through loan financing. This information allows you to complete summary Lines 24 through 26. Under Part E - Final Status, you can also check that your analysis is complete. In other ability to pay cases, your review of the violator's cash flow and equity position might demonstrate that the partnership does not have funds available for the penalty. These cases will require an in-depth investigation of each partner. Determining each partner's individual ability to pay will give you an assessment of the funds that each can contribute towards a penalty. Follow the worksheets and instructions in this document for assistance in analyzing each partner. For general partners that are Subchapter C corporations, consult Chapter 3. For partners that are Subchapter S corporations, consult Chapter 4. For partners who are individuals, consult Chapter 7. For partners that are themselves partnerships, use the worksheets in this chapter. Keep in mind that limited partners are only liable to the extent of their investment.

Clearly the number and variety of the partners in a partnership will add to the complexity of your analysis. For help on those cases that involve many partners and/or complicated relationships, consult a financial analyst.

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[8] PLD's land is worth an estimated $9.0 million. Assuming partnership debt capacity of 70 to 80 percent (all dollars are in millions):

a) $9.0 x 0.80 = $7.2 - $2.5 (current mortgage) = $4.7
b) $9.0 x 0.70 = $6.3 - $2.5 = $3.8

PARTNERSHIP

EXTENDED ABEL ANALYSIS

Section I. General Information

1. Violator's name:	
2. Address:	
3. Type of partnership (check one): _______ Limited _______ General	
4. Principal business activity and product or service (1065, items A and B):	

5. Original penalty amount	
6. As a percent of income (penalty ÷ Line 8 on Form 1065)	

Section II. Financial Information

7. Tax returns and schedules available	Year Prepared

8. Financial Statements provided	Audited? Y or N	Period(s) covered

Section II. Financial Information (continued)

9. Other violator or general industry information collected and date of document(s):

PARTNERSHIP

EXTENDED ABEL ANALYSIS

Section III. Ownership and Operating Affiliations (from tax form, Financial Statements and D&B report)

Part A. Partner Information

General Partner:	
Type of entity:	
Percent ownership:	
Guaranteed payments to partner:	

General Partner:	
Type of entity:	
Percent ownership:	
Guaranteed payments to partner:	

General Partner:	
Type of entity:	
Percent ownership:	
Guaranteed payments to partner:	

Part B. Other Partnerships

	Yes	No
Is the violator a partner in any other partnerships?		

Name of partnership:	
Principle business activity:	
Information required for further analysis:	

EXTENDED ABEL ANALYSIS

Section IV. Business Assets (Use data from 1065 Schedule L, compare with Financial Statements)

Part A. Luxury Assets

Asset and use	Estimated market value and source	Balance due on loan	Replacement cost	Potentially available
10. Total potentially available net of replacement				

Part B. Undervalued Assets

Asset and Use	Book value	Estimated market value	Value difference
11. Total estimated excess value of assets			

Section V. Business Expenses

Expenses

Expenses category	Amount expended	Possible reduction
12. Total possible reduction in expenses		

Provide justification for reductions specified above:

PARTNERSHIP

EXTENDED ABEL ANALYSIS

Section VI. Case Disposition

Part A. Cash Flow

13.	Total Partnership Income	
		+
14.	Depreciation/Depletion/Amortization	
		=
15.	Total pre-tax cash flow	
		+
16.	Total estimated reduction in expenses	
		+
17.	Estimated pre-tax cash flow	
		=
18.	Tax adjustment [0.67 x Line 17]	
19.	Non-cash deduction tax benefit (Line 14 x 0.33)	
20.	Estimated after-tax cash flow (Line 18 + Line 19)	

Part B. Equity Assessment (Partners' Capital Accounts)

Asset Liquidation

21.	Estimated excess value of luxury or unnecessary assets	

Equity Valuation

22.	Adjusted partnership assets (subtract liquidated assets)	
		+
23.	Estimated excess value of undervalued assets	
		=
24.	Adjusted value of assets	
25.	Estimated adjusted equity (adjusted assets minus liabilities)	

PARTNERSHIP

EXTENDED ABEL ANALYSIS

Section VI. Case Disposition (continued)

Part C. Case Disposition

26. Violator's estimated after-tax cash flow for 19 _____	
27. Estimated assets potentially available for liquidation	
28. Violator's estimated adjusted equity	

Part D. Final Status

☐	Analysis completed
☐	Pursuing further analysis

Analyst's Name ____ Date____________

Form **1065**

Department of the Treasury
Internal Revenue Service

U.S. Partnership Return of Income

For calendar year 1991, or tax year beginning ...., 1991, and ending ...., 19 ....

▶ See separate instructions.

OMB No. 1545-0099

1991

A Principal business activity	Use the IRS label. Otherwise, please print or type.	Name of partnership	D Employer identification number
B Principal product or service		Number, street, and room or suite no. (If a P.O. box, see page 9 of the instructions.)	E Date business started
C Business code number		City or town, state, and ZIP code	F Total assets (see Specific Instructions) $

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address (4) ☐ Amended return

H Check accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶ ....

I Number of partners in this partnership ▶ ....

Caution: *Include only trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.*

Income

1a	Gross receipts or sales	1a		
b	Less returns and allowances	1b	1c	
2	Cost of goods sold (Schedule A, line 8)		2	
3	Gross profit. Subtract line 2 from line 1c		3	
4	Ordinary income (loss) from other partnerships and fiduciaries *(attach schedule)*		4	
5	Net farm profit (loss) *(attach Schedule F (Form 1040))*		5	
6	Net gain (loss) from Form 4797, Part II, line 18		6	
7	Other income (loss) (see instructions) *(attach schedule)*		7	
8	**Total income (loss).** Combine lines 3 through 7		8	

Deductions (see instructions for limitations)

9a	Salaries and wages (other than to partners)	9a		
b	Less jobs credit	9b	9c	
10	Guaranteed payments to partners		10	
11	Rent		11	
12	Interest		12	
13	Taxes		13	
14	Bad debts		14	
15	Repairs		15	
16a	Depreciation (see instructions)	16a		
b	Less depreciation reported on Schedule A and elsewhere on return	16b	16c	
17	Depletion **(Do not deduct oil and gas depletion.)**		17	
18	Retirement plans, etc.		18	
19	Employee benefit programs		19	
20	Other deductions *(attach schedule)*		20	
21	**Total deductions.** Add the amounts shown in the far right column for lines 9c through 20		21	
22	**Ordinary income (loss)** from trade or business activities. Subtract line 21 from line 8		22	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner) is based on all information of which preparer has any knowledge.

▶ Signature of general partner ▶ Date

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ▶ ☐	Preparer's social security no.
Firm's name (or yours if self-employed) and address ▶		E.I. No. ▶	
		ZIP code ▶	

Schedule A Cost of Goods Sold

1	Inventory at beginning of year	1	
2	Purchases less cost of items withdrawn for personal use	2	
3	Cost of labor	3	
4	Additional section 263A costs (see instructions) *(attach schedule)*	4	
5	Other costs *(attach schedule)*	5	
6	**Total.** Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9a Check all methods used for valuing closing inventory:
- (i) ☐ Cost
- (ii) ☐ Lower of cost or market as described in Regulations section 1.471-4
- (iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c)
- (iv) ☐ Other (specify method used and attach explanation) ▶ ....

b Check this box if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)* ▶ ☐

c Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? ☐ **Yes** ☐ **No**

d Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ **Yes** ☐ **No**
If "Yes," attach explanation.

Schedule B Other Information

		Yes	No
1	Is this partnership a limited partnership?		
2	Are any partners in this partnership also partnerships?		
3	Is this partnership a partner in another partnership?		
4	Is this partnership subject to the consolidated audit procedures of sections 6221 through 6233? If "Yes," see **Designation of Tax Matters Partner** below		
5	Does this partnership meet **all** the requirements shown in the instructions for **Question 5?**		
6	Does this partnership have any foreign partners?		
7	Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		
8	Has this partnership filed, or is it required to file **Form 8264,** Application for Registration of a Tax Shelter?		
9	At any time during the tax year, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See the instructions for exceptions and filing requirements for form TD F 90-22.1.) If "Yes," enter the name of the foreign country ▶		
10	Was the partnership the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not the partnership or any partner has any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		
11	Was there a distribution of property or a transfer (for example, by sale or death) of a partnership interest during the tax year? If "Yes," you may elect to adjust the basis of the partnership's assets under section 754 by attaching the statement described under **Elections** on page 5 of the instructions		

Designation of Tax Matters Partner (See instructions.)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶ ______ Identifying number of TMP ▶ ______

Address of designated TMP ▶ ______

Schedule K Partners' Shares of Income, Credits, Deductions, Etc.

Section	(a) Distributive share items		(b) Total amount
Income (Loss)	1 Ordinary income (loss) from trade or business activities (page 1, line 22)	1	
	2 Net income (loss) from rental real estate activities *(attach Form 8825)*	2	
	3a Gross income from other rental activities — 3a		
	b Less expenses *(attach schedule)* — 3b		
	c Net income (loss) from other rental activities	3c	
	4 Portfolio income (loss) (see instructions):		
	a Interest income	4a	
	b Dividend income	4b	
	c Royalty income	4c	
	d Net short-term capital gain (loss) *(attach Schedule D (Form 1065))*	4d	
	e Net long-term capital gain (loss) *(attach Schedule D (Form 1065))*	4e	
	f Other portfolio income (loss) *(attach schedule)*	4f	
	5 Guaranteed payments to partners	5	
	6 Net gain (loss) under section 1231 (other than due to casualty or theft) *(attach Form 4797)*	6	
	7 Other income (loss) *(attach schedule)*	7	
Deductions	8 Charitable contributions (see instructions) *(attach list)*	8	
	9 Section 179 expense deduction *(attach Form 4562)*	9	
	10 Deductions related to portfolio income (see instructions) (itemize)	10	
	11 Other deductions *(attach schedule)*	11	
Investment Interest	12a Interest expense on investment debts	12a	
	b (1) Investment income included on lines 4a through 4f above	12b(1)	
	(2) Investment expenses included on line 10 above	12b(2)	
Credits	13a Credit for income tax withheld	13a	
	b Low-income housing credit (see instructions):		
	(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990	13b(1)	
	(2) Other than on line 13b(1) for property placed in service before 1990	13b(2)	
	(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989	13b(3)	
	(4) Other than on line 13b(3) for property placed in service after 1989	13b(4)	
	c Qualified rehabilitation expenditures related to rental real estate activities *(attach Form 3468)*	13c	
	d Credits (other than credits shown on lines 13b and 13c) related to rental real estate activities (see instructions)	13d	
	e Credits related to other rental activities (see instructions)	13e	
	14 Other credits (see instructions)	14	
Self-Employment	15a Net earnings (loss) from self-employment	15a	
	b Gross farming or fishing income	15b	
	c Gross nonfarm income	15c	
Adjustments and Tax Preference Items	16a Accelerated depreciation of real property placed in service before 1987	16a	
	b Accelerated depreciation of leased personal property placed in service before 1987	16b	
	c Depreciation adjustment on property placed in service after 1986	16c	
	d Depletion (other than oil and gas)	16d	
	e (1) Gross income from oil, gas, and geothermal properties	16e(1)	
	(2) Deductions allocable to oil, gas, and geothermal properties	16e(2)	
	f Other adjustments and tax preference items *(attach schedule)*	16f	
Foreign Taxes	17a Type of income ▶ .... b Foreign country or U.S. possession ▶		
	c Total gross income from sources outside the U.S. *(attach schedule)*	17c	
	d Total applicable deductions and losses *(attach schedule)*	17d	
	e Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	17e	
	f Reduction in taxes available for credit *(attach schedule)*	17f	
	g Other foreign tax information *(attach schedule)*	17g	
Other	18a Total expenditures to which a section 59(e) election may apply	18a	
	b Type of expenditures ▶		
	19 Other items and amounts required to be reported separately to partners (see instructions) *(attach schedule)*		
Analysis	20a Income (loss). Combine lines 1 through 7 in column (b). From the result, subtract the sum of lines 8 through 12a, 17e, and 18a	20a	

b Analysis by type of partner:

	(a) Corporate	(b) Individual — Active	(b) Individual — Passive	(c) Partnership	(d) Exempt organization	(e) Nominee/Other
(1) General partners						
(2) Limited partners						

SCHEDULE K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

Partner's Share of Income, Credits, Deductions, Etc.

► See separate instructions.

For calendar year 1991 or tax year beginning , 1991, and ending , 19

OMB No. 1545-0099

1991

Partner's identifying number ►

Partnership's identifying number ►

Partner's name, address, and ZIP code

Partnership's name, address, and ZIP code

A Is this partner a general partner? ☐ Yes ☐ No

B Partner's share of liabilities (see instructions):

Nonrecourse $ ....

Qualified nonrecourse financing $ ....

Other $ ....

C What type of entity is this partner? ► ....

D Is this partner a ☐ domestic or a ☐ foreign partner?

E IRS Center where partnership filed return:

F Enter partner's percentage of:

	(i) Before change or termination	(ii) End of year
Profit sharing	%	%
Loss sharing	%	%
Ownership of capital	%	%

G(1) Tax shelter registration number ► ....

(2) Type of tax shelter ► ....

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) ☐

I Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

J **Analysis of partner's capital account:**

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))

		(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1	Ordinary income (loss) from trade or business activities	1		(See Partner's Instructions for Schedule K-1 (Form 1065))
	2	Net income (loss) from rental real estate activities	2		
	3	Net income (loss) from other rental activities	3		
	4	Portfolio income (loss):			
	a	Interest	4a		Sch. B, Part I, line 1
	b	Dividends	4b		Sch. B, Part II, line 5
	c	Royalties	4c		Sch. E, Part I, line 4
	d	Net short-term capital gain (loss)	4d		Sch. D, line 4, col. (f) or (g)
	e	Net long-term capital gain (loss)	4e		Sch. D, line 11, col. (f) or (g)
	f	Other portfolio income (loss) *(attach schedule)*	4f		(Enter on applicable line of your return.)
	5	Guaranteed payments to partner	5		(See Partner's Instructions for Schedule K-1 (Form 1065))
	6	Net gain (loss) under section 1231 (other than due to casualty or theft)	6		
	7	Other income (loss) *(attach schedule)*	7		(Enter on applicable line of your return.)
Deductions	8	Charitable contributions (see instructions) *(attach schedule)*	8		Sch. A, line 13 or 14
	9	Section 179 expense deduction	9		(See Partner's Instructions for Schedule K-1 (Form 1065))
	10	Deductions related to portfolio income *(attach schedule)*	10		
	11	Other deductions *(attach schedule)*	11		
Investment Interest	12a	Interest expense on investment debts	12a		Form 4952, line 1
	b	(1) Investment income included on lines 4a through 4f above	b(1)		(See Partner's Instructions for Schedule K-1 (Form 1065))
		(2) Investment expenses included on line 10 above	b(2)		
Credits	13a	Credit for income tax withheld	13a		(See Partner's Instructions for Schedule K-1 (Form 1065))
	b	Low-income housing credit:			
		(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
		(2) Other than on line 13b(1) for property placed in service before 1990	b(2)		
		(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
		(4) Other than on line 13b(3) for property placed in service after 1989	b(4)		
	c	Qualified rehabilitation expenditures related to rental real estate activities (see instructions)	13c		(See Partner's Instructions for Schedule K-1 (Form 1065))
	d	Credits (other than credits shown on lines 13b and 13c) related to rental real estate activities (see instructions)	13d		
	e	Credits related to other rental activities (see instructions)	13e		
	14	Other credits (see instructions)	14		

		(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
ployment	15a	Net earnings (loss) from self-employment	15a		Sch. SE, Section A or B
	b	Gross farming or fishing income	15b		(See Partner's Instructions for Schedule K-1 (Form 1065))
	c	Gross nonfarm income	15c		
Adjustments and Tax Preference Items	16a	Accelerated depreciation of real property placed in service before 1987	16a		(See Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 6251.)
	b	Accelerated depreciation of leased personal property placed in service before 1987	16b		
	c	Depreciation adjustment on property placed in service after 1986	16c		
	d	Depletion (other than oil and gas)	16d		
	e	(1) Gross income from oil, gas, and geothermal properties	e(1)		
		(2) Deductions allocable to oil, gas, and geothermal properties	e(2)		
	f	Other adjustments and tax preference items *(attach schedule)*	16f		
Foreign Taxes	17a	Type of income ▶			Form 1116, Check boxes
	b	Name of foreign country or U.S. possession ▶			Form 1116, Part I
	c	Total gross income from sources outside the U.S. *(attach schedule)*	17c		
	d	Total applicable deductions and losses *(attach schedule)*	17d		
	e	Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	17e		Form 1116, Part II
	f	Reduction in taxes available for credit *(attach schedule)*	17f		Form 1116, Part III
	g	Other foreign tax information *(attach schedule)*	17g		See instructions for Form 1116
Other	18a	Total expenditures to which a section 59(e) election may apply	18a		See Partner's Instructions for Schedule K-1 (Form 1065)
	b	Type of expenditures ▶			
	19	Recapture of low-income housing credit			
	a	From section 42(j)(5) partnerships	19a		Form 8611, line 8
	b	Other than on line 19a	19b		

Supplemental Information

20 Supplemental information required to be reported separately to each partner *(attach additional schedules if more space is needed)*:

Caution: *Read the instructions for* **Question 5** *of Schedule B on page 14 of the instructions before completing Schedules L, M-1 and M-2.*

Schedule L Balance Sheets

	Beginning of tax year		End of tax year	
Assets	**(a)**	**(b)**	**(c)**	**(d)**
1 Cash				
2a Trade notes and accounts receivable				
b Less allowance for bad debts				
3 Inventories				
4 U.S. government obligations				
5 Tax-exempt securities				
6 Other current assets *(attach schedule)*				
7 Mortgage and real estate loans				
8 Other investments *(attach schedule)*				
9a Buildings and other depreciable assets				
b Less accumulated depreciation				
10a Depletable assets				
b Less accumulated depletion				
11 Land (net of any amortization)				
12a Intangible assets (amortizable only)				
b Less accumulated amortization				
13 Other assets *(attach schedule)*				
14 **Total assets**				
Liabilities and Capital				
15 Accounts payable				
16 Mortgages, notes, bonds payable in less than 1 year				
17 Other current liabilities *(attach schedule)*				
18 All nonrecourse loans				
19 Mortgages, notes, bonds payable in 1 year or more				
20 Other liabilities *(attach schedule)*				
21 Partners' capital accounts				
22 **Total** liabilities and capital				

Schedule M-1 Reconciliation of Income per Books With Income per Return

1 Net income per books		5 Income recorded on books this year not included on Schedule K, lines 1 through 7 (itemize)	
2 Income included on Schedule K, lines 1 through 7, not recorded on books this year (itemize)		a Tax-exempt interest $	
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 12a, 17e, and 18a (itemize):		6 Deductions included on Schedule K, lines 1 through 12a, 17e, and 18a, not charged against book income this year (itemize).	
a Depreciation $		a Depreciation $	
b Travel and entertainment $		7 Total of lines 5 and 6	
4 Total of lines 1 through 3		8 Income (loss) (Schedule K, line 20a). Line 4 less line 7	

Schedule M-2 Analysis of Partners' Capital Accounts

1 Balance at beginning of year		6 Distributions: a Cash	
2 Capital contributed during year		b Property	
3 Net income per books		7 Other decreases (itemize):	
4 Other increases (itemize)			
		8 Total of lines 6 and 7	
5 Total of lines 1 through 4		9 Balance at end of year. Line 5 less line 8	

*U.S. Government Printing Office: 1991 — 285-219

A sole proprietorship is a business entity owned and operated by an individual. As with partnerships, sole proprietorships are not subject to federal income tax; rather, the income from the business is passed on to the owner. Income from the business is reported on the Individual Federal Income Tax return Form 1040, Schedule C, and is taxed along with other income the individual might receive.

A sole proprietor is responsible in full for the liabilities of his or her company. Often, the income, assets, and liabilities of a sole proprietorship are indistinguishable from those of the owner. For this reason, an ability to pay analysis of a sole proprietorship should also include an analysis of the owner's assets, liabilities and expenses. This chapter presents a method for conducting such a combined analysis.[1]

To analyze a sole proprietorship, enforcement staff will have to collect information on both the business and the individual. As with the other business entities discussed in this manual, you will need to obtain complete tax returns for the past three years (Form 1040, plus Schedule C and any other relevant schedules) and any available financial statements for the business.[2] Individuals should also complete and return to the EPA an Individual Financial Data Request Form (IFDRF), a blank copy of which can be found at the end of this chapter. On this form, individuals provide detailed information about their personal assets, liabilities, and expenses.

The ability to pay process for sole proprietors is a slightly different approach than that for a corporation or business. The sole proprietor worksheets begin with some basic information about the company, followed by an analysis of the proprietor's <u>combined</u> personal and business income. Next we assess the violators's equity by evaluating his or her assets and liabilities. In the final worksheet section, we calculate the violator's cash flow and equity.

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[1] Chapter 7 presents a method for analyzing individuals only. The worksheets in the Chapter 7 should be used when analyzing an individual <u>without</u> an operating business, or those individuals involved in partnerships or corporations that have personal responsibility for their company's liabilities.

[2] If the sole proprietor has not prepared financial statements, they can complete a copy of the Sole Proprietorship Balance Sheet attached to the Individual Financial Data Request Form.

Because of the depth and detail required in these cases, we will work with a sample case through this chapter. Before completing the sole proprietorship worksheet, be certain that you have read Chapter 2, as it contains important information on the questions in this worksheet.

Section I - General Information

The first section of the worksheet summarizes basic information about the violator, and information that has been collected thus far. Throughout this case we will use the example of Russ T. Tank, the sole proprietor of a gasoline service station.

- **Violator (Business):** On Line 1, enter the name of the business, noted in Item C on Schedule C of the Form 1040.[3] In our example, the business name is Tank's Full of Gasoline.

- **Address:** On Line 2, enter the violator's business address, which is Item E on Schedule C of the Form 1040. Tank's business address is 60 Madison Road, Alvord, Iowa.

- **Proprietor:** On Line 3, enter the name of the business proprietor, reported on the top line of Schedule C.

- **Principal business activity and product or service:** On Line 4, enter the violator's principal business activity, along with its product or service. This information can be found on Form 1040, Schedule C, Item A.

- **Original Penalty Amount:** Note on Line 5 the proposed penalty amount.

Section II - Financial Information

In this section of the worksheet we summarize the financial available information.

- **Tax returns and schedules.** On Line 6, enter the forms and schedules supplied, along with the year of the return. Note also whether any tax information is missing. For Tank and his service station we have Form 1040 and Schedule C for 1989, 1990, and 1991. Tank has also attached Schedules A, B, SE and E to his personal return.

- **Financial Statements.** On Line 7, list all available financial information. This should include the IFDRF that the violator completed. The violator should also provide Balance Sheets and Income Statements for the business. Note the period covered by each statement, particularly if the statement covers only a portion of a fiscal year. Also note whether any necessary or useful

[3] Throughout this chapter we reference the 1991 version of the Form 1040. Specific item locations may differ for previous years' forms.

information is missing. Tank has sent Income Statements and Balance Sheets for his business covering fiscal years 1989, 1990 and 1991.

- **Other information on violator or industry.** On Line 8, list any other material you have obtained. Examples of such information include Dun & Bradstreet reports, a company prospectus, loan applications, and so forth. Note as well the period covered by the document. For our example, we were able to obtain a common-size statement for service stations with total assets below $50 million to use in our asset and liability analysis.[4]

Section III - Ownership and Operating Affiliations

This worksheet section details relationships that the violator has with other businesses. This information will indicate whether entities beyond the violator and his or her company should be considered in the ability to pay analysis. For example, check to see if the sole proprietor is also an officer or controlling shareholder in a closely held corporation, a partner in a partnership, or the owner of another sole proprietorship. This information should have been provided in the violator's Individual Financial Data Request Form.

- **Additional business concerns.** Is the owner or is the business affiliated with any other business concerns? Check yes or no. Tank is not affiliated with any other business.

- **Name of Entity.** Note the name of each related entity.

- **Type of entity.** Note whether the entity is a corporation, partnership, or sole proprietorship.

- **Relationship and documents available.** Describe here the relationship between the two entities, and the percentage of the business owned by the violator. Also note any documents on the related entity that are currently available.

In the summary portion of this section of the worksheet, discuss whether other entities should be included in the ability to pay assessment for this violator. In many instances this determination will require advice from a financial expert. Continue to work on the violator's ability to pay assessment while you pursue information about the proprietor's other business interests.

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[4] Common-size statements compare assets, liabilities, income and expenses across businesses within an industry. These statements generally show the average percentage of net sales or total assets consumed by each category of expenses or liabilities. Consult Chapter 2 and Appendix A for ideas on additional sources of industry information.

Section IV - Income

In this section of the worksheet, we evaluate the violator's income as reported on its most recent Form 1040 tax return. Income for the violator will consist of the income produced by the sole proprietorship, and any other income claimed on the violator's Form 1040.

Part A - Business Income

In Part A we compute business income by adding back paper write-offs and (if necessary) adjusting expenses.

- **Business income.** Note the violator's business income as reported on Line 12 of the 1040 form. From Tank's return we see that he has claimed $38,208 in business income. To obtain more information about the business, refer to Schedule C - Profit or Loss for Business.

- **Depletion.** On Line 13 of the worksheet, record any depletion that the violator has claimed for his or her business (See Line 12 of Schedule C). Tank did not claim any depletion for his station. Enter zero on Line 13.

- **Depreciation and/or Amortization.** On Line 14 of the worksheet, record any depreciation or amortization that the violator has claimed for his or her business. Depreciation and amortization are real business costs; however, they do not increase a company's annual cash outflows. For that reason, depreciation and amortization expenses are added back into a company's income when computing cash flow. On Line 13 of Tank's Schedule C, he claimed $4,115 in depreciation for the year. Enter this figure on Line 14 of the worksheet.

- **Total business income.** Enter the total of the values on Lines 12 through 14 on Line 15. Tank's total business income equals $42,323.

Part B - Personal Income

In this section, we sum other sources of income as reported on the individual's Form 1040. In some cases, the violator may have sources of income that are not taxable, but that should be included in his or her total income for purposes of this analysis.

- **Wage income.** On Line 16 of the worksheet, enter the violator's wage income as reported on Line 7 of the Form 1040. Tank's wage income in 1991 was $11,401.

- **Taxable interest income.** From Line 8a on Form 1040, note if the violator has claimed taxable interest income. Examples of taxable interest income include interest from checking and savings accounts, and interest from bonds and treasury bills. (See the 1040 Instruction Booklet for a full explanation of each line entry.) In our example, Tank has claimed $2,265 in taxable interest for the year. Enter this on Line 17 of the Worksheet.

- **Tax-exempt interest income.** From Line 8b on Form 1040, note if the violator has claimed tax-exempt interest income. An example of tax-exempt interest is the interest earned on a municipal bond. Tank has not made an entry in this line. Enter zero on Line 18.

- **Dividend income.** On Line 19 of the worksheet, enter any dividend income reported in Line 9 of the tax return. Enter zero for Tank since he did not report dividend income.

- **Alimony received.** On Line 20 of the worksheet, enter alimony reported in Line 11 of the tax return. Enter zero for Tank since he did not report any alimony.

- **Total IRA distributions.** On Line 21 of the worksheet, enter any distributions from IRA funds reported in Line 16 of the tax return. If an entry is made in both Line 16a (total value) and Line 16b (taxable portion), enter the amount from Line 16a. However, if the IRA distribution is fully taxable, an entry will be made in Line 16b only. If this is the case, enter the amount from Line 16b. Enter zero for Tank since he did not report any IRA distributions.

- **Total pensions and annuities.** On Line 22 of the worksheet, enter any pension and annuity income reported in Line 17 of the tax return. If an entry is made in both Line 17a (total value) and Line 17b (taxable portion), enter the amount from Line 17a. However, if the pension is fully taxable, an entry will be made in Line 17b only. If this is the case, enter the amount from Line 17b. Enter zero for Tank since he did not report any pension or annuity income.

- **Total social security.** On Line 23 of the worksheet, enter any Social Security income reported in Line 21a of the tax return. Be careful to enter the value on 21a (the total) and <u>not</u> the value in the rightmost Line 21b. (The value in Line 21b represents <u>only</u> the taxable social security; here we want to account for <u>all</u> income.) Enter zero for Tank since he did not report any Social Security income.

- **Total income (or loss) from rental or royalty properties.** On Line 18 of Form 1040, the filer is asked to record income from rents, royalties, partnerships, estates and trusts. To get a breakdown of each of these income sources, we need to consult Schedule E, which details each of these income sources. If an entry is made in Line 18, a Schedule E must accompany the 1040 tax return. Tank has claimed $2,340 in rental income on his Schedule E. Enter this figure on Line 24 of the worksheet.

- **Depreciation or depletion on rental property.** Recall that to calculate an violator's net business cash flow, we must add back the depletion and depreciation expenses claimed on the tax form. Therefore, we add back depreciation on rental property to calculate cash flow from this asset. Note that on Line 20 of Schedule E, Tank has claimed a depreciation expense of $680. Enter this amount on Line 25.

- **Partnership/Subchapter S corporation income.** Also on Schedule E, violators must detail income or loss from Partnerships and Subchapter S Corporations. The total income from these sources is recorded on Line 31 of Schedule E. Enter this amount on Line 26 of the worksheet. Enter zero for Tank since he did not report this type of income.

- **Estate and trust income.** Also on Schedule E, violators must detail income or loss from Estates or Trusts. The total income from these sources is recorded on Line 36 of Schedule E. Enter this amount on Line 27 of the worksheet. Enter zero for Tank since he did not report any estate or trust income.

- **REMIC income.** Also on Schedule E, violators must detail income (or loss) they receive as a holder of a residual interest in a Real Estate Mortgage Investment Conduit (REMIC). The total income from these sources is recorded on Line 38 of Schedule E. Enter this amount on Line 28 of the worksheet. Enter zero for Tank since he did not report any REMIC income.

- **Farm rental income.** If a violator has received income from farm property that he or she is renting to someone else, he or she must declare this income on a Schedule E. Note if income has been recorded on Line 39 of the Schedule E. If so, enter this amount on Line 29 of the worksheet. Enter zero for Tank since he did not report any farm rental income.

- **Depreciation on farm rental income.** Individuals can claim depreciation expenses on the farm property they rent to others, just as they do on other rental properties. We add this expense back when calculating cash flow. Tank does not rent any farm property or claim depreciation, so enter zero on Line 30 of the worksheet.

- **Farm income.** A violator must submit a Schedule F to report income and expenses from a farm that he or she operates, or owns and operates.[5] If an entry was made in Line 19 of the 1040 return, a Schedule F must accompany the 1040 return. If income is declared on Line 19 of the 1040 form, enter this figure on Line 31 of the worksheet. Enter zero for Tank.

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[5] Normally, farmers report income from a crop in the year it is sold. However, because farmers can pledge part or all of their production to secure government payments (e.g., CCC loans, PIK certificates), they can elect to report a payment as income in the year it is received, rather than the year of crop sale. If claimed as income these payments will be noted on Line 7A of Schedule F. While these loans represent income, we do not recommend that they be treated as cash.

- **Depreciation on farm property.** Depreciation on farm property and equipment is recorded on Line 17 of the Schedule F. As with depreciation on other types of property, this expense is added back to calculate cash flow. On Line 32 of the worksheet, enter the amount reported on Line 17 of the Schedule F. Enter zero for Tank.

- **Capital gain (loss).** From the 1040 tax form, add Lines 13 and 14 and enter this total on Line 33 of the worksheet. Tank did not claim any capital gains or losses for the year.

- **Other gains (losses).** Enter the amount recorded on Line 15 of the 1040 tax form on Line 34 of the worksheet. Tank did not claim any additional gains or losses for the year.

- **Total personal income.** Add Lines 16 through 34 of the worksheet and enter the proprietor's total personal income on Line 35. Tank's total personal income (exclusive of that from his business) is $16,686.

- **Total income.** Add personal income on Line 35 to business income on Line 15, and enter the total on Line 36. Tank's total income equals $59,009.

Section V - Net Cash Flow

The next step in this analysis involves determining the violator's cash flow. A simple way to think of cash flow is the income left over after paying all cash expenses during a year. In calculating expenses, we use data from the Current Living Expenses section of the Individual Financial Data Request Form (Part II).

- **Total annual living expenses.** Go to Part II of the violator's Financial Data Form. Space for converting data to annual values is provided in the "For Agency Use Only" column in the Current Living Expenses Section (Part II). For weekly expenses, multiply by 52 and put the total in the "For Agency Use Only" column. For monthly expenses, multiply by 12; and for quarterly expenses multiply by 4. Sum this column of figures, ignoring Federal Income Taxes (Line D.2 on the Financial Data Form), and enter the result on Line 37 of the worksheet.[6] Russ T. Tank's total annual living expenses, before Federal Income Taxes are $37,087.

- **Total annual debt payment.** Enter the violator's total annual personal debt expenses. A violator's current debt expenses are important to determining the violator's ability to acquire additional debt. Total lines B.1 through B.4 on the Current Living Expenses Form. Enter this total on Line 38 of the worksheet. Tank spends $9,769 on personal debt (his business debt equals $71,341 as noted in Items 16a and 16b on Schedule C).

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[6] We ignore Federal Income Tax payments at this point because our cash-flow adjustments must be done on a pre-tax basis; we will adjust for this later.

- **Cash Flow.** Once we have totalled income and expenses, we can calculate the violator's cash flow for the year. Subtract Line 37 from Line 36. Tank's pre-tax cash flow is $21,922. Enter this amount on Line 39.

Expense Evaluation

We now want to estimate whether the violator could improve cash flow by reducing business or personal expenses. As noted in Chapter 2, business expenses might mask resources actually going to the proprietor (e.g., high business travel expenses might actually include family vacation expenses). Review these expenses (detailed in Form 1040, Part II of Schedule C) and, if possible, compare them to industry averages. Do any expenses seem significantly above average values? Also examine personal expenses (detailed in Part II "Current Living Expenses" of the IFDRF); do any of them seem out of line?

It might help to compare the proprietor's expenses to those noted in the Consumer Price Index measure of the relative importance of household expenditures included at the end of this chapter. This index lists the percentage of income spent on certain goods and services for the average U.S. urban household. Individual expenses clearly will vary from these measures, but the index can be a useful guide for determining the general range of household expenses. On the worksheet, note the business and personal expenses that seem to be high, along with the reductions you think might be possible.

- **Expense Category.** List the expenses that you believe are inflated, or that can be reduced without materially affecting the operations of the business or the proprietor's standard of living.

- **Amount.** Note the annual amount for each expense that you believe can be reduced.

- **Possible reduction.** Enter the reduction that you find to be reasonable.

- **Justification for reduction.** Describe here your reasons for any possible reductions.

- **Total possible reduction in expenses.** On Line 40, sum all possible reductions in expenses.

- **Adjusted pre-tax cash flow.** Add any possible reductions in expenses to pre-tax cash flow and enter the total on Line 41. This total represents additional cash flow that the violator may be able to generate if expenses can be reduced. Our review of Tank's personal and business expenses indicates that they are reasonable, and within the guidelines we consulted.

Section VI - Net Worth

The next section of the analysis evaluates the violator's net worth. Net worth is measured by subtracting liabilities from assets; it is similar to the notion of corporate equity, as it measures the material value of an entity or individual. To evaluate a sole proprietorship's net worth, we must assess both personal and business assets and liabilities. The data for our analysis come from the Net Worth Section (Part III) of the IFDRF, and the business Balance Sheet. We continue our example with Russ T. Tank below.

Part A - Business and Personal Assets

Our review begins with the proprietor's personal assets. On Lines 42 through 49 of the 1040 worksheet, we enter subtotals for asset category specified on the Individual Financial Data Request Form.

- **Bank accounts.** Enter the subtotal from Question 1 on the Data Request Form on Line 42 of the worksheet. Tank has a total of $19,301 in checking and savings accounts.

- **Investments.** On Line 43 of the worksheet, enter the subtotal for the violator's investments. Tank has $20,000 in investments.

- **Retirement funds and accounts.** Enter the subtotal from this question on Line 44. Tank has zero in retirement funds.

- **Life insurance policies.** Enter the subtotal from Question 4 on Line 45. The value of Tank's life insurance policy equals $7,800.

- **Vehicles.** On Line 46, enter the violator's estimate of the value of his vehicles. Tank has entered $24,000 for this question.

- **Personal property.** On Line 47 of the worksheet, enter the value of the violator's personal property. For Tank this total is $17,000.

- **Real estate.** On Line 48 of the worksheet, enter the subtotal for the value of all real estate. Tank estimates this value to be $78,000.

- **Other assets.** In Question 8, the violator totals the value of all other assets. Tank has not listed any other assets. Therefore, enter zero on Line 49.

- **Total personal assets.** Add Lines 42 through 49 on the worksheet and enter this amount on Line 50. The total value of Tank's personal assets is $166,101.

- **Business assets.** Review the assets of the business as stated on the proprietor's Balance Sheet, checking whether any <u>personal</u> assets listed by the proprietor are also claimed as business assets. On Line 51 note the total for the business assets. Tank's total business assets are valued at $471,419

- **Total assets.** On Line 52, enter the sum of the values on Lines 50 and 51 above. This figure represents the proprietor's combined business and personal assets. The value of Tank's business and personal assets equals $637,520.

Part B - Asset Evaluation

Our next step is to assess these assets to determine if any costly business or personal assets are undervalued. Review the list of assets carefully. Do the given values seem reasonable? The worth of assets valued at over $5,000 should be double-checked against outside sources. Vehicle values are published in industry "blue books," available at car dealerships. Industry analysts or associations can often estimate the value of business or industrial equipment. County or local property assessors should be able to verify the value of land and/or buildings in their jurisdiction. Provide information in this section on only those assets that are undervalued.

- **Asset and use.** Describe the asset and its use.

- **Book value.** Note the value as stated on the proprietor's Balance Sheet or his or her Financial Data Request Form.

- **Estimated market value.** Note the market value of the asset and the source for this information.

- **Value difference.** Subtract the book value from the market value and enter this difference.

- **Estimated excess value of assets.** Sum the difference between estimated market value and book value of all undervalued assets and enter the amount on Line 53.

- **Revised asset total.** Sum the additional asset value as noted and enter the adjusted asset value on Line 54. Our evaluation of Tank's assets indicate that they are properly valued.

Part C - Business and Personal Liabilities

Next we review all personal and business liabilities. On Lines 55 through 59, enter information about the proprietor's personal liabilities. Again, the data for our analysis comes from the Net Worth Section (Part III) of the IFDRF, and the business Balance Sheet. We begin with personal liabilities.

- **Credit cards and lines of credit.** On Line 55, enter credit debt for the violator. Tank's total is $17,021.

- **Vehicle loans.** Enter on Line 56 the subtotal for all car loans. Tank still owes $12,560.

- **Furniture and household goods loans.** On Line 57, enter any debt acquired for household goods. Tank has entered $3,923.

- **Mortgages and real estate loans.** Enter any outstanding real estate mortgage balances on Line 58. Tank still owes $32,760 on his home.

- **Other debt.** Note whether violator has listed any other debt. Here Tank enters a personal loan in the amount of $19,035. Enter this figure on Line 59.

- **Total personal liabilities.** On Line 60, total all of the violator's liabilities. Tank's total is $85,299.

- **Business liabilities.** Review the liabilities of the business as stated on the Balance Sheet, checking whether any personal liability listed by the proprietor are also claimed as business liability. Subtract from the business liability total liabilities claimed on both the Balance Sheet and the Individual Financial Data Request Form. On Line 61, note the total for the business liabilities. Tank's total business liabilities equal $274,662.

- **Total liabilities.** On Line 62, enter the sum of the values on Lines 60 and 61 above. This figure represents the proprietor's combined business and personal liabilities. Tank's business and personal liabilities equal $359,961.

Part D - Net Worth Calculation

Once you have reviewed and totaled the value of all business and personal assets, you can calculate the violator's net worth.

- **Net Worth.** Subtract Line 62 from Line 54 to determine the violator's net worth. (Keep in mind that this <u>can</u> be a negative number. Negative net worth simply means that an individual's debt is greater than his or her assets.) Tank's net worth equals $277,559 and is entered on Line 63 of the Worksheet.

- **Liability-to-asset ratio.** Divide Line 62 by Line 54 to obtain the violator's liability-to-asset ratio. This ratio simply shows the percentage by which the violator's assets are offset by liabilities. Tank's liability-to-asset ratio is 0.56. This means that his assets cover somewhat less than half his liabilities. Enter this ratio on Line 64 of the worksheet.

<u>Section VII - Case Disposition</u>

Determining ability to pay for a sole proprietor follows the same basic steps as the determination for other entities. First we assess the violator's cash flow, that is, the amount of income remaining after deducting all cash expenses. Recall that in our income assessment above, we evaluate and combine business and personal income and expenses, as personal and business funds overlap in many sole proprietorships. Next, we assess the individual's net worth, that is, the value of all personal and business assets after deducting liabilities or debt.

Part A - Cash Flow

In Section IV above you calculated the violator's net cash flow. The purpose of this calculation is to determine what amount, if any, the individual might be able to contribute towards a penalty payment, from readily available funds. In assessing the portion of this amount that might go towards a penalty, it is a good idea to set aside an "emergency" or contingency allowance to cover the violator's unexpected expenses for the year ahead. This contingency amount should equal five to fifteen percent of the violator's personal expenses. The percentage you select should be based on the violator's income, as compared to national or local medians and family size. Use a higher contingency percentage for lower income households. In our example, Tank's income of $59,009 is approximately 170 percent of median income for a family of five in Iowa (his home state). We therefore might set aside a lower contingency allowance (five percent of income), because his income is relatively high.

- **Pre-tax cash flow.** On Line 65, enter the amount from Line 41 of this worksheet.

- **Contingency percentage.** On Line 66, enter the percentage of expenses for the violator's contingency. We determined, based on his income, that Tank's contingency should equal five percent of his personal expenses.

- **Contingency amount.** Multiple the percentage on Line 66 by the value on Line 37 for the proprietor's contingency amount. Enter this total on Line 67. Tank's contingency equals $1,854 ($37,087 x .05).

- **Available pre-tax cash flow (net of contingency).** Subtract Line 67 from Line 65 for the proprietor's available cash flow. Enter this total on Line 68. Tank's pre-tax cash flow equals $20,068 ($21,922 - $1,854).

- **Tax adjustment.** Adjust for taxes by multiplying pre-tax cash flow on Line 68 by one minus the maximum individual tax rate (1 - 0.33 = 0.67). Enter the result on Line 69.

- **Non-cash deduction tax benefits.** Add together the amounts on Lines 13, 14, 25, 30 and 32. Multiply the total ($4,795) by the tax rate (0.33) and enter the result on Line 70.

- **After-tax cash flow.** Add together Lines 69 and 70, and enter the result on Line 71.

From these calculations, we see that Tank can provide approximately $15,028 in after-tax cash to fund a penalty ([$20,068 x 0.67] + [$4,115 + 680] x 0.33).

Part B - Net Worth Assessment

The next step is to determine if the violator might be able to pay a penalty through the sale of some assets or through assuming additional debt. In Part E of Section V above, you calculated the sole proprietor's net worth. At issue here is what portion of this net worth can be used to fund a penalty payment. Obviously, lower income individuals, or individuals with fixed incomes will be less able to replace assets or to borrow funds. As a general rule of thumb, low income, unemployed, or retired individuals should maintain an liability-to-asset ratio of 0.5 to 0.6. If the individual's liability-to-asset ratio is above this value, financing a penalty through a loan should not be considered. As an individual's income rises, the baseline liability-to-asset ratio can be relaxed somewhat, to perhaps 0.7 to 0.8 for younger, high income violators that can pay off debt over a longer period.

In our example, Tank is 48 years old and his income is about 170 percent of the median for a Iowa family of five. Based on this information, we might select a baseline liability-to-asset ratio ("target ratio") of 0.7 for this violator. Our selection means that any asset liquidation or new debt that Tank acquires to fund a penalty should not cause his liability-to-asset ratio to exceed 0.7. If the violator's current liability-to-asset ratio falls below this target, excess assets may be available. In our analysis, we calculate a dollar figure for this potential excess.

You must also consider what portion of the violator's income is applied toward current debt. The criterion generally applied by banks and other lending institutions is that an individual's total debt (mortgage and other housing obligations, credit cards and other loans) should not exceed 36 percent of gross income. Tank's percentage of personal debt to income (on Line 38 of this worksheet) is 17 percent, indicating that he probably has additional debt capacity.

Below, we summarize information about our sample case with Russ T. Tank.

- **Net worth.** Enter on Line 72 the net worth figure from Line 63 above. Tank's net worth is $277,559.

- **Target liability to asset ratio.** Enter on Line 73 the target ratio you will apply to this violator, based on age and income. Our target for Tank is 0.7.

- **Target assets.** We next want to determine the necessary assets for this violator, based on his or her target liability-to-asset ratio. To determine this dollar amount, divide Line 62 (Total liabilities) by Line 73 (Target ratio). Tank's liabilities equal $359,961. If we divide this by 0.7 we get a dollar figure of $514,230, which represents the amount of assets Tank should maintain. Enter this percentage on Line 74.

- **Available assets.** We next want to estimate the violator's available assets, that is, the value of assets that might be available for environmental costs. We find this value by subtracting the violator's target assets from his or her actual assets. For Tank, subtract Line 74 ($514,230) from Line 54 ($637,520). The result is $123,290. Enter this on Line 75.

- **Percentage of debt payment to annual income.** Divide Line 38 on this worksheet by Line 36 to determine the portion of the proprietor's income that goes to debt. Enter this percentage on Line 76. Tank's personal debt to income ratio is 0.17 or 17 percent ($9,769 ÷ $59,009).

The cash flow and net worth calculations give us an <u>estimate</u> of the funds available for a penalty. Again, it is important to point out that this analysis requires a measure of judgment as to the violator's "ability to pay." We have tried to provide enforcement staff with a framework for assessing a sole proprietor's cash flow and net worth; however, the guidelines are general and are not meant to serve as "hard-and-fast" rules.

Individual Financial Data Request Form

This form requests information regarding your personal financial status. The data will be used to evaluate your ability to pay for environmental clean-up or penalties. If there is not enough space for your answers, please use additional sheets of paper. Note that we may request further documentation of any of your responses. We welcome any other information you wish to provide supporting your case, particularly if you feel your situation is not adequately described through the information requested here.

Certification

I declare that this statement of assets, liabilities, and other information is true, correct, and complete to the best of my knowledge and belief.

Signature	Date
Russ T. Tank	3/28/92

Name: RUSSELL T. TANK	Age: 48
Address: 132 WASHINGTON RD ALVORD, IA	

PART I. BACKGROUND INFORMATION

1. MEMBERS OF HOUSEHOLD (List the head of the household and all persons living with you)

Name	Age	Relationship to Head of Household	Currently Employed?
RUSSELL T. TANK	48	CO-HEAD	YES
LENORA P. TANK	48	CO-HEAD	YES
BRUCE TANK	17	SON	NO
JAY TANK	13	SON	NO
TAMMY TANK	10	DAUGHTER	NO

2. EMPLOYMENT (List all jobs held by persons in household)

Name	Employer	Length of Employment	Annual Salary
RUSS TANK	SELF-EMPLOYED; GAS STATION	18 YRS	no fixed salary
LENORA TANK	ALVORD MEMORIAL HOSPITAL	8 YRS	$11,401
BRUCE TANK	TANK'S FULL OF GAS	2 SUMMERS	$2,500

PART II. CURRENT LIVING EXPENSES

Please list personal living expenses which were typical during the last year and indicate if any of these values are likely to change significantly in the current year. Please do not include business expenses. If you are the owner of an operating business, please attachment any available financial statements.

Expense	Amount	Period of Payment (check one)				For Agency Use Only
		Weekly	Monthly	Quarterly	Yearly	
A. Living Expenses						
1. Rent						
2. Home maintenance	100			✓		400
3. Auto fuel maint./other transp.	45	✓				2,337
4. Utilities						
a. Fuel (gas,oil,wood,propane)	158		✓			1,900
b. Electric	72		✓			864
c. Water/sewer	24		✓			288
d. Telephone	132		✓			1,584
5. Food	91	✓				4,726
6. Clothing, personal care	433		✓			5,197
7. Medical costs	519			✓		2,075
B. Debt Payments						
1. Mortgage payments	520		✓			6,240
2. Car payments	286		✓			3,429
3. Credit card payments	25			✓		100
4. Educational loan payments						
C. Insurance						
1. Household insurance	41			✓		162
2. Life insurance	105			✓		420
3. Automobile insurance	1,600					1,600
4. Medical insurance	760					760
D. Taxes						
1. Property taxes	264			✓		1,056
2. Federal income taxes	5,399				✓	(ignore)
3. State income taxes	1,079				✓	1,079
4. FICA	820				✓	820
E. Other Expenses						
1. Childcare						
2. Current School tuition/expenses	400			✓		1,600
3. Legal or professional services	450				✓	450
4. Other (itemize on separate page)						
Total Current Expenses						37,087

PART III. NET WORTH

1. BANK ACCOUNTS (Checking, NOW, Savings, Money Market, etc.)

Name of Bank or Credit Union	Type of Account	Current Balance
FIRST ALVORD	CHECKING	12,219
" "	"	1,462
" "	SAVINGS	5,620
For Agency Use Only - Total Current Balance in Bank Accounts		19,301

2. INVESTMENTS (Stock, Bonds, Mutual Funds, Options, Futures, CD's, Real Estate Investment Trusts (REIT), etc.)

Investment	Number of Shares or Units	Current Market Value
CD (FIRST ALVORD)	1	$10,000
" " "	1	10,000
For Agency Use Only - Total Current Market Value of Investments		20,000

3. RETIREMENT FUNDS AND ACCOUNTS (IRA, 401(k), Keough, vested interest in company retirement fund, etc.)

Description of Account	Estimated Market Value
For Agency Use Only - Total Estimated Market Value of Retirement Funds and Accounts	

4. LIFE INSURANCE POLICIES

Policy Holder	Issuing Company	Policy Value	Cash Value
RUSSELL TANK	MUTUAL OF OMAHA	15,000	4,800
LENORA TANK	" " "	10,000	3,000
For Agency Use Only - Total Value of Life Insurance Policies			7,800

5. VEHICLES (Cars, Trucks, Motorcycles, Recreation Vehicles, Motor Homes, Boats, Airplanes, etc.)		
Model	Year	Estimated Market Value
CHEVY 4x4	1990	$ 14,000
LINCOLN CONT.	1988	8,000
FORD ESCORT	1987	2,000
For Agency Use Only - Total Estimated Market Value of Vehicles		24,000

6. PERSONAL PROPERTY (Household Goods and Furniture, Jewelry, Art, Antiques, Collections, Precious Metals, etc. Only list items with a value greater than $500.00)	
Type of Property	Estimated Market Value
FURNITURE	12,000
HOUSEHOLD APPLIANCES	5,000
For Agency Use Only - Total Estimated Market Value of Personal Property	17,000

7. REAL ESTATE (Land, Buildings, Land with Buildings)		
Location	Description of Property	Estimated Market Value
132 WASHINGTON RD.	2 ACRES, HOUSE, GARAGE	78,000
For Agency Use Only - Total Estimated Market Value of Real Estate		78,000

8. OTHER ASSETS	
Type of Asset	Estimated Market Value
For Agency Use Only - Total Other Assets	

9. CREDIT CARDS AND LINES OF CREDIT		
Credit Card/Line of Credit (Type)	Owed To	Balance Due
ALVORD S+L CREDIT LINE	ALVORD S+L	10,000
SEARS DISCOVER CARD	SEARS	1,028
ALVORD CITY VISA	ALVORD S+L	3,596
FIRST AMERICAN VISA	FIRST AMERICAN BANK	2,397
For Agency Use Only - Total Balance Due on Credit Cards and Lines of Credit		17,021

10. VEHICLE LOANS (Cars, Trucks, Motorcycles, Recreation Vehicles, Motor Homes, Boats, Airplanes, etc.)		
Vehicle (Model and Year)	Owed To	Balance Due
CHEVY 4x4 (1990)	FIRST ALVORD S+L	8,600
LINCOLN CONT. (1988)	" " "	3,960
For Agency Use Only - Total Balance Due on Vehicle Loans		12,560

11. FURNITURE AND HOUSEHOLD GOODS LOANS:		
List Item	Owed To	Balance Due
LIVINGROOM FURNITURE	HAHN'S FURNITURE	3,923
For Agency Use Only - Total Balance Due on Furniture and Household Goods Loans		3,923

12. MORTGAGES AND REAL ESTATE LOANS			
Type of Loan	Owed To	Property Secured Against	Balance Due
HOME MORTGAGE	ALVORD S+L	132 WASHINGTON	32,760
For Agency Use Only - Total Balance Due on Mortgages and Real Estate Loans			32,760

13. OTHER DEBT (Amounts due to individuals, Fixed obligations, Taxes Owed, Overdue Alimony or Child Support, etc.)

Type of Debt	Owed To	Balance Due
PERSONAL LOAN	ALFRED B. TANK	19,035
For Agency Use Only - Total Balance Due on Other Debt		19,035

PART IV. ADDITIONAL INFORMATION

Please respond to the following questions. For any question that you answer "Yes," please pr
additional information on separate pages or at the bottom of this page.

QUESTION	YES	NO
1. Do you have any reason to believe that your financial situation will change during the next year?	X	
2. Are you currently selling or purchasing any real estate?		X
3. Are you involved or affiliated with any other sole proprietorships, parterships or corporations?		X
4. Is anyone (or any entity) holding real or personal property on your behalf (e.g., a trust)?		X
5. Are you a party in any pending lawsuit?		X
6. Have any of your belongings been repossessed in the last three years?		X
7. Are you a Trustee, Executor, or Administrator?		X
8. Are you a participant or beneficiary of an estate or profit sharing plan?		X
9. Have you declared bankruptcy in the last seven years?		X
10. Do you receive any type of federal aid or public assistance?		X

MY SON BRUCE IS GOING TO COLLEGE NEXT YEAR. I EXPECT ADDITIONAL EXPENSES (TUITION, ROOM + BOARD) OF ABOUT $2,000.

SOLE PROPRIETORSHIP

EXTENDED ABEL ANALYSIS

Section I. General Information

1. Violator (Business): Tank's Full of Gasoline

2. Address: 60 Madison Ave.
Alvord, IA

3. Proprietor: Russell T. Tank

4. Principal business activity and product or service (Schedule C, Item A):
Gasoline service station

5. Original penalty amount	

Section II. Financial Information

6. Tax returns and schedules	Year Prepared
Form 1040, schedules A, B, C, SE and E	1989
" " " " " " " "	1990
" " " " " " " "	1991

7. Financial Statements	Period(s) covered
Income statement and Balance Sheet for station	Fiscal 1989
" " " " " " "	" 1990
" " " " " " "	" 1991
Individual Financial Data Request Form	1992

Section II. Financial Information (continued)

8. Other information on violator or industry:

Common-size statement for service stations with total assets less than $50 million

(from Robert Morris Associates)

SOLE PROPRIETORSHIP

EXTENDED ABEL ANALYSIS

Section III. Ownership and Operating Affiliations

Additional business concerns (check and answer where applicable)	Yes	No
9. Is this corporation affiliated with any other business concerns (e.g., corporations, partnerships, sole proprietorships)		X

10. If Yes, provide the following information:

Name of entity	Type of entity	Relationship and documents available

11. Summary: Discuss possible expansion of Ability to Pay analysis

SOLE PROPRIETORSHIP

EXTENDED ABEL ANALYSIS

Section IV - Income

Part A. Business Income

12. Business income (from Line 12 on 1040)	$ 38,208
13. Depletion (1040 Schedule C, Line 12)	+ $ 0
14. Depreciation and/or Amortization (1040 Schedule C, Line 14)	+ $ 4,115
15. Total business income	= $ 42,323

Part B. Personal Income

16. Wage income (Line 7 on tax form)	$ 11,401
17. Taxable interest income (Line 8a on tax form)	$ 2,265
18. Tax-exempt interest income (Line 8b on tax form)	$ 0
19. Dividend income (Line 9 on tax form)	$ 0
20. Alimony received (Line 11 on tax form)	$ 0
21. Total IRA distributions (from tax form: if Lines 16a and 16b are both greater than zero, enter the amount on 16a; if Line 16a is zero and line 16b is positive, enter the value on Line 16b)	$ 0
22. Total pensions and annuities (from tax form: if Lines 17a and 17b are both greater than zero, enter the amount on 17a; if Line 17a is zero and line 17b is positive, enter the value on Line 17b)	$ 0
23. Total social security (Line 21a on tax form)	$ 0

SOLE PROPRIETORSHIP

EXTENDED ABEL ANALYSIS

24. Total income or (loss) from rental properties or royalties (Schedule E of tax form, Line 22)	$ 2,340
25. Depreciation or depletion on rental property (Schedule E of tax form, Line 20 total all properties)	$ 680
26. Partnership/S corporation income or (loss) (Schedule E of tax form, Line 31)	$ 0
27. Estate and trust income or (loss) (Schedule E of tax form, Line 36)	$ 0
28. REMIC income or (loss) (Schedule E of tax form, Line 38)	$ 0
29. Farm rental income or (loss) (Schedule E of tax form, Line 39)	$ 0
30. Depreciation on farm rental property (Form 4835, Line 13)	$ 0
31. Farm income or (loss) (Line 19 on tax form)	$ 0
32. Depreciation on farm property (Schedule F of tax form, Line 17)	$ 0
33. Capital gain or (loss) (Lines 13 plus 14 on tax form)	$ 0
34. Other gains or (losses) (Line 15 on tax form)	$ 0
35. **Total personal income (add Lines 16 through 34)**	$ 16,686
36. **Total income (add Lines 15 and 35)**	$ 59,009

SOLE PROPRIETORSHIP

EXTENDED ABEL ANALYSIS

Section V. Net Cash Flow

37. Total annual living expenses, net Federal Income Taxes (convert expenses from Part II of Financial Data Request form to annual values and sum; ignoring Line D.2)	$ 37,087
38. Total annual debt payment (Part II of Individual Financial Data Request form, sum entries in section "B. Debt Payments")	$ 9,769
39. Pre-tax cash flow (subtract Line 37 from Line 36)	$ 21,922

Expense Evaluation

Expense Category	Amount	Possible reduction	Justification for reduction
40. Total possible reduction in expenses (Sum the possible reductions):		$ 0	

41. Adjusted pre-tax cash flow: (Line 39 + Line 40)	$ 21,922

SOLE PROPRIETORSHIP

EXTENDED ABEL ANALYSIS

Section VI. Net Worth

Part A. Business and Personal Assets

42. Bank accounts (Part III of Individual Financial Data Request form, total from III.1)	$ 19,301
43. Investments (Part III of Individual Financial Data Request form, total from III.2)	$ 20,000
44. Retirement funds and accounts (Part III of Individual Financial Data Request form, total from III.3)	$ 0
45. Life insurance policies (Part III of Individual Financial Data Request form, total from III.4)	$ 7,800
46. Vehicles (Part III of Individual Financial Data Request form, total from III.5)	$ 24,000
47. Personal property (Part III of Individual Financial Data Request form, total from III.6)	$ 17,000
48. Real estate (Part III of Individual Financial Data Request form, total from III.7)	$ 78,000
49. Other assets (Part III of Individual Financial Data Request form, total from III.8)	$ 0
50. Total personal assets (sum Lines 42 through 49)	$ 166,101
51. Business assets (from Sole Proprietorship balance sheet)	$ 471,419
52. Total assets (Line 50 + Line 51)	$ 637,520

Section VI. Net Worth (continued)

Part B. Asset Evaluation

Asset and Use	Book Value	Estimated Market Value	Value Difference
53. Total estimated excess value of assets			$ 0

54. Revised asset total (Line 52 + Line 53)	$ 637,520

Part C. Business and Personal Liabilities

55. Credit cards and lines of credit (Part III of Individual Financial Data Request form, total from III.9)	$ 17,021
56. Vehicle loans (Part III of Individual Financial Data Request form, total from III.10)	$ 12,560
57. Furniture and household goods loans (Part III of Individual Financial Data Request form, total from III.11)	$ 3,923
58. Mortgages and real estate loans (Part III of Individual Financial Data Request form, total from III.12)	$ 32,760
59. Other debt (Part III of Individual Financial Data Request form, total from III.13)	$ 19,035
60. Total personal liabilities (sum Lines 54 through 59)	$ 85,299
61. Business liabilities (from Sole Proprietorship balance sheet)	$ 274,662
62. Total liabilities (Line 60 + Line 61)	$ 359,961

SOLE PROPRIETORSHIP

EXTENDED ABEL ANALYSIS

Section VI. Net Worth (continued)

Part D. Net Worth Calculation

63. Net Worth (subtract Line 62 from Line 54)	$ 277,559
64. Liability-to-Asset Ratio (divide Line 62 by Line 54)	56 %

Section VII. Case Disposition

Part A. Cash Flow

65. Pre-tax cash flow (from Line 41)	$ 21,922
66. Contingency percentage (enter the contingency percentage for expenses)	5 %
67. Contingency amount (multiply Line 66 by Line 37)	$ 1,854
68. Available pre-tax cash flow net of contingency (subtract Line 67 from Line 65)	$ 20,068
69. Tax adjustment (Line 68 x 0.67)	$ 13,446
70. Non-cash deduction benefits	$ 1,582
71. Estimated after-tax cash flow (Line 69 + Line 70)	$ 15,028

SOLE PROPRIETORSHIP

EXTENDED ABEL ANALYSIS

Part B. Net Worth Assessment

72. Net Worth (from Line 63 above)	$ 277,559
73. Target Liability-to-Asset Ratio	70 %
74. Target assets (divide line 62 by Line 73)	$ 514,230
75. Available assets (subtract Line 74 from Line 54)	$ 123,290
76. Percentage of debt payment to annual income (divide Line 38 by Line 36)	17 %

Analyst's Name Gary Goodguy Date 5/12/92