

Say "Yes" to Good Loans.

SAMPLE PAGES FROM
CASHFLOW ANALYSIS
OF PARTNERSHIP
& CORPORATION
TAX RETURNS

2006 FORMS AND SCHEDULES

LINDA GABBERT KEITH, CPA, CSP

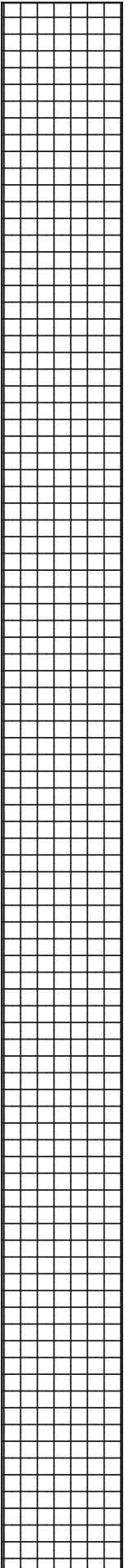
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***Please note:** This publication is designed to provide accurate and authoritative information in regard to the subject covered. It is sold with the understanding that the author is not engaged in rendering legal or accounting service. This manual should not be used as a substitute for adequate training or consultations with professional advisors, when necessary.*

Policies and procedures vary. Consult the policies and procedures of your company or a senior lender before making adjustments recommended here.

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WELCOME! In this workshop on cashflow analysis of tax returns we will explore the mysteries of partnership and corporate tax returns. They seem more intimidating because lenders aren't generally as familiar with the forms. At least we have all seen a Form 1040!

The work we do will build on the information presented in CASHFLOW ANALYSIS OF 1040 TAX RETURNS. (If you did not attend that program or study that manual it is assumed you have attended comparable training and/or have a good working knowledge of the basics of cashflow analysis and the 1040 tax return.)

We will use the same approach, the same cashflow worksheet and the same procedure. We will be looking for the same types of adjustments.

The difference: we will be looking for them in new and different places. We will also work on becoming familiar enough with the forms that you can make reasonable assumptions and ask informed questions.

You may encounter partnership and corporate returns less frequently than sole proprietorships. If so, it would be wise to put your head together with another or a more experienced lender after you have done the first run-through of the return.

Being able to understand and use tax returns is definitely a use-it-or-lose-it skill and infrequency of use will require greater assistance when the time comes.

Part of the benefit of this information will be to learn the difference between what you should understand and what is generally going to be beyond your understanding.

There is a point at which it is not realistic for a lender to have complete understanding of the tax treatment of a transaction. The issue is the impact on cashflow and whether it is recurring or not.

Question the borrower or (with permission) the tax preparer. Focus on



cash impact and likelihood of recurrence. You will generally get the information you need to determine the effect on future cashflow.

By the end of this study, you will:

- ✓ Understand the basic differences between sole proprietorships, partnerships, corporations and S corporations.
- ✓ Know which forms they file.
- ✓ Have a basic familiarity with these forms.
- ✓ Be able to use common sense and an inquisitive approach to determine the recurring cash impact of the various business interests represented in the tax returns.
- ✓ Understand how the issue of % ownership impacts your decision on whether to add cashflow generated by the business instead of that which the borrower actually received in cash.
- ✓ Ask informed questions.
- ✓ Determine a figure for cashflow from the various types of businesses that is *reasonably* likely to be a recurring source of income to service the debt of the business or the owner.

We use the **ADJUSTMENT METHOD** when analyzing business tax returns.

In the adjustment method, you start with the bottom line of the tax return. I call this 'tax return income' but the official label is Adjusted Gross Income (AGI) on a 1040, Ordinary Income on a partnership or S corporation return and Taxable Income (before NOL and special deductions) on a corporate return.

You then review the information in the return to make adjustments to this bookkeeping/tax number to get to the real number you are interested in: **recurring cashflow available to your borrower.**

The ADJUSTMENT METHOD requires you look at every income and expense item on the return, not just those that are most familiar.

You need to review each item in a return and know what items may *not* be there that *do* impact cashflow. You will need to know how to decide what to include and not to include in cashflow. The information you gain from this manual will help you.

HISTORICAL VERSUS PROJECTED

A variation in approach is when you do a historical analysis first and then project future cashflow, instead of doing it all in one step. I teach a one-step method, adjusting for nonrecurring and optional items as we go. I find commercial lenders sometimes prefer the two-step approach because it gives them a better picture of the historical cashflow of the business for the past several years.

On page 1-11, I distinguish between historical (actual) cashflow adjustments and projecting adjustments. It is your

choice, one step or two.

DEBT-COVERAGE OR DEBT-SERVICE RATIO

With a debt-service approach, the income *before* interest deductions is divided by the debt. A debt service ratio of 1.2 to 1.5 or more is common. Higher ratios are often required with lower liquidity.

With a closely-held business, the debt figure used often combines personal, rental and business debt. Check your internal guidelines.

DEBT-TO-INCOME RATIO

With debt-to-income ratios, the *personal debt* is generally divided by the *net cashflow from all sources*. Those sources can include wages, investment income, rental activities and self-employment.

Interest related to the business or rental activities is added back and the full debt payments are *subtracted from income* rather than included on the personal debt list. Debt-to-income ratios range from 35% to 50% if compared to gross wages...or 45% to 60% if compared to net wages (after-tax income).

BEFORE-TAX VERSUS AFTER-TAX

Before-tax figures are most commonly used for consumer and mortgage lending, and often for commercial lending. With this approach, you don't have to modify the tax you count against the borrower due to adjustments made for nonrecurring or optional items. Doing so can be complicated because some cashflow adjustments relate to income *and* self-employment tax...others only to income tax.

If you use after-tax figures your guideline for debt-to-income ratio will typically be higher and you will have to consider adjusting the tax figure you subtract from cashflow for significant nonrecurring or optional items.

NET OPERATING LOSSES (NOLs)

These are caused by deductions from a trade or business, deductions from work as an employee, or deductions for casualty or theft loss that exceeded income in a previous year. Partners or S corporation shareholders pass-through NOLs to their individual returns so you only find NOLs reducing 1040 or corporation income.

Generally, you can carry an NOL forward 15 to 20 years, depending on when it was incurred. Any carryforward in a tax return is a **noncash item**.

If on the 1040, add it back when using the AGI method. Ignore it when using the Schedule Analysis Method. The NOL deduction should be listed as a negative on the "Other Income" line of the 1040 (Line 21).

On a corporation, the NOL is shown on Line 29 of the return. If you start your cashflow analysis with taxable income before NOLs and special deductions (Line 28) you don't need to add back the NOL because it didn't reduce your starting number.

However, if you start your corporate analysis with taxable income (Line 30) you'll need to add back the NOL.

A statement must be attached to the tax return that shows the pertinent facts of the NOL. In addition, Form 1120 Schedule K Line 12 should show the NOL carryover from prior years. Details of how the NOL is computed are somewhat complex and not relevant to the lender.

A taxpayer with additional NOL to carry forward has less tax to pay next year than a comparable taxpayer with no NOL to shelter taxes.

When considering before-tax cashflow, a borrower with a continuing NOL could 'afford' a higher debt-to-income ratio or a lower debt-service ratio than someone who has to pay taxes on all of their income. You may choose to consider this in your loan recommendation, usually as a compensating factor.

If you use after-tax cashflow, consider

whether the NOL has been 'used up'. If there is no more NOL to shelter income, taxes next year will be higher. Consider subtracting from cashflow a higher amount of taxes than was shown in the tax return.

LIKE-KIND EXCHANGES

When the borrower has exchanged one type of business or investment property for another, and no cash has changed hands, there will be no gain or loss.

Like-Kind Exchanges are reported on Form 8824 which is required to be attached to the return.

If there is recognizable gain because the borrower's property was worth more than the property exchanged for and so received cash in addition to the other property, that amount will come in on Line 4 or 11 of the Schedule D or Line 5 or 16 on Form 4797.

Keep in mind that the piper must eventually be paid. The basis of the 'new' investment property is the basis of the 'old' property. So when the new property is sold, the gain will be based on the original cost of the earlier property.

Example:

Property A cost \$100,000 and you made \$150,000 improvements. The basis is now \$250,000 and it is worth \$600,000. If you sell it, you'll pay on the \$350,000 gain now.

Instead, trade it for like-kind property worth \$600,000. The basis of the new property is transferred, \$250,000.

Make improvements to that property of \$300,000. The basis is now \$550,000.

Sell that property for \$1,500,000. Your gain is \$950,000.

That gain really is \$350,000 from the first property (\$600,000 proceeds less \$250,000 basis) and \$600,000 from the second property (\$600,000 'cost' plus \$300,000 improvements for a basis of \$900,000, compared to the sales price of \$1,500,000).

You benefit by paying taxes later rather than sooner...but you eventually pay the taxes.

FROM 'TAX RETURN INCOME' TO RECURRING CASHFLOW

Since the tax return was not designed to give creditors information about the cashflow available to potential borrowers , we have some adjustments to make to the 'bottom line' of the tax return...Ordinary income in a partnership or S corporation, Taxable Income (before NOL and special deductions) in a regular corporation.

HISTORICAL/ACTUAL.....

NONTAXED INCOME/GAIN

NONDEDUCTED EXPENSE/LOSS

NONCASH INCOME OR EXPENSE

Definition:

Definition:

Definition:

Income/Gain examples:

Income/Gain examples:

Expense/Loss examples:

Expense/Loss examples:

Add to cashflow.

Source:

Corp:

Schedule M-1

Pship or Scorp:

Schedule K and M-1

Subtract from cashflow.

Subtract income or add back expense if it was included in your starting number.

EXERCISE

This exercise is based on information that was presented in the 1040 manual. Give it a try based on that information or, if you have not seen my version of this before, your own knowledge and experience. There are 6 N's that represent the types of adjustments in any return.

Think of additional examples for each. These examples can be personal or business. If you are not in class with me, when you are done check the solutions section in the back of the manual for my ideas.

PROJECTED/RECURRING.....

NEW INCOME/EXPENSE

Definition:

Income/Gain examples:

Expense/Loss examples:

Add income or subtract expense if projecting.

NONRECURRING INCOME/EXPENSE

Definition:

Income/Gain examples:

Expense/Loss examples:

Subtract income or add back expense if it was included in your starting number. I include in this category optional expenses.

NONDOCUMENTED INCOME

Definition:

Income/Gain examples:

Subtract income if it was included in your starting number. Make note that it may be recurring and counted in cashflow if documented.

This procedure will assist in keeping track; help document the process, questions and judgment calls; provide a tool for *selling* the loan recommendation and enable senior lenders to evaluate it.

1. *ALWAYS USE A WORKSHEET!*

2. *PROCEED LINE-BY-LINE* through the first two pages of Form 1040 or the first page of a business return. When you come to a line that is carried forward from another Form or Schedule, circle that number and trace it to its source. Proceed line-by-line down that schedule, then return to the page from which you came. For business returns, there is a **Source of Adjustments** section opposite the first page of each return in this manual that lists the schedules with possible adjustments.

3. *FOR EACH ENTRY ON THE RETURN,* choices:

ADJUSTMENT METHOD (1040s AND BUSINESS RETURNS)

...no adjustment necessary, OR

...adjustment necessary and can be determined with information available.

Enter on appropriate line of the cashflow worksheet, OR

...not sure, adjustment cannot be determined from information available or need additional documentation. Enter on question sheet.

SCHEDULE ANALYSIS (1040s ONLY)

...include in cashflow, enter on worksheet, OR

...do not include in cashflow, enter reason on worksheet, OR

...need additional information or documentation, enter on question sheet, OR

...if business or rental schedule, use bottom-line income and see adjustment method.

4. *AFTER EACH FORM OR SCHEDULE HAS BEEN REVIEWED* look at the worksheet section for that form to see that you have considered all important items. Then put a check mark at the bottom of that page on the tax return and go back to the schedule/form you came from.

5. *IF THE TAXPAYER HAS INCOME FROM A CONTROLLED CORPORATION, PARTNERSHIP OR S CORPORATION* use the 1040 as the master tax return and handle each source entity as it feeds into the 1040 (on the wage line for Corporations and Schedule E, Page 2 for Partnerships and S corporations).

6. If doing a personal analysis, *CONTINUE THROUGH PAGE TWO* of Form 1040. *WHEN YOU ARE TO THE BOTTOM OF PAGE TWO* you should have reviewed each page of the tax return. Confirm this by flipping through the pages and looking for your check mark at the bottom of each.

7. *RUN A TAPE* of the adjustments you are sure of and assumptions on the questions you have for the borrower. If there is no way they can qualify you may have enough information to decline the loan at this step. If they qualify by leaps and bounds then perhaps you do not need to ask **all** of the questions you had in mind.

8. *RESOLVE QUESTIONS* requiring a phone call to the borrower, consultation with another lender or both. Note on the question sheet who you spoke to, the date and time. If you are not confident of the questions you have for the borrower, run them by another lender first.

9. *ENTER RESPONSES TO QUESTIONS* in the worksheet if the answer you received from the borrower impacts cashflow. **SHOW ALL CALCULATIONS!**

10. *NOW ADD UP THE NUMBERS.* Do they qualify?

Corporations (also called c corporations) are separate legal entities from the persons who own them. With a closely held corporation, the owner/shareholder often works for the corporation as an employee. For tax and legal purposes, the two are separate.

ADVANTAGES:

- Limited Liability
- Greater access to capital (3 F's)
- Employee benefits for owners

DISADVANTAGES:

- More complicated to start, maintain and dissolve than a sole proprietorship
- Important to keep records clearly and separate
- Costs more to setup and maintain than a sole proprietorship
- Double taxation

TAX FORM:

Form 1120
U.S. Corporate Return

TAX IMPACT ON OWNER:

Owner is taxed on income actually received from the corporation. Typically this is wages and bonuses. It can also be rent of business property owned by the borrower personally, dividends, and interest on repayment of loans from the borrower/owner. The corporation is taxed as a separate entity.

COMMERCIAL LENDERS:

Your main interest is whether cashflow from operations is sufficient to adequately cover current and proposed debt.

Equally important is whether the business appears to be healthy. Watch for major changes or a shift from a stable to a fast-growing or declining business.

Commercial lenders often choose not to assume that excess corporate cashflow will be drawn out in the form of higher owner wages. When doing the analysis on the guarantor of the business loan, your choice.

CONSUMER OR MORTGAGE LENDERS:

If the borrower is a low % owner, use the same guidelines you would use if the borrower were a wage earner working for any other company.

If the borrower is a higher % owner, give credit for his/her share of additional cashflow generated by the company over and above wages taken.

If the cashflow from operations was not sufficient to support the wages taken, this could result in a negative adjustment.

Keep in mind that not all cashflow generated by operations is available to pay personal debts. Other uses of excess business cashflow include expansion, inventory increase and purchase of equipment. You can review the balance sheet in the return to understand how the company is using any excess cashflow.

Your company's internal guidelines rather than the traditional 51% determine the % ownership that indicates sufficient control. I have seen this as low as 10% and as high as 35%. A 25% ownership is commonly used as the cutoff for determining whether you must review the full corporate returns and use cashflow available instead of actual wages.

Some lenders have trouble with the idea of giving the borrower credit for additional cashflow when they own as little as 25%.

The reason for the low % is the concern that there may be a significant loss the lender should know about. Even if the borrower owns as little as 25%, a closely-held corporation running a large loss could have significant negative impact on the borrower's cashflow as s/he tries to cover the loss and make guaranteed loan payments.

A variation: Your guidelines could require the full return at 25%, but only make positive adjustments to personal cashflow with 51%+ ownership.

 SELF STUDY STUDENTS:

See page 4-3 to fill in blanks on next page.

WHAT DOES IT LOOK LIKE?

