TO: Central Valley Regional Water Board
Prosecution Team

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DATE: July 8, 2013

SUBJECT: HENRY J. TOSTA JR. FAMILY, L.P. DAIRY'S ABILITY TO PAY ADMISTRATIVE CIVIL LIABILITY COMPLAINT NO. R5-2012-0561

Summary

This memo is in response to your request of November 13, 2012 for a determination of Henry J. Tosta Jr. Family, L.P Dairy's (Discharger) ability to pay the Administrative Civil Liability (Complaint No. R5-2012-0561) in the amount of $1,140,713.

The Porter-Cologne Act requires that when setting civil liabilities, the regional board shall take into consideration the ability to pay and to continue in business.[1] It is the conclusion of this analysis that the Discharger has not made a compelling case to conclude that the Discharger does not possess the financial resources to pay the ACL.

The Discharger has the ability to pay the proposed liability due to an improving income and cash flow situation, and a strong equity position. Negative income was realized from 2008 through 2011 but in the year 2012, total cash flow was $652,794, a significant improvement and a positive indication of future financial health.

The Discharger's principal source of funds to pay the ACL is $1,632,944 of equity capital as reflected in the 2012 balance sheet. The equity capital can be used as collateral to finance the payment of the proposed $1,140,713 ACL and continue to remain in business.

Ability to Pay

The Water Resources Control Board's Penalty Calculation Methodology provides a consistent approach and analysis of factors to determine administrative civil liability.[2] Step 6 provides guidance in determining ability to pay and to continue in business.

> The ability of a discharger to pay an ACL is determined by its revenues and assets. In most cases, it is in the public interest for the discharger to continue in business and bring its operations into

[1] Water Quality Enforcement Policy, Office of Enforcement, State Water Resources Control Board, November 17, 2009, Page 11.
[2] Op. Cite., Pages 9-21.

compliance. If there is strong evidence that an ACL would result in widespread hardship to the service population or undue hardship to the discharger, the amount of the assessment may be reduced on the grounds of ability to pay.[3]

The Discharger's business is organized as a limited partnership consisting of a general partner and two limited partners. The general partner is an individual but the limited partners consist of a trust and an irrevocable family trust. The ability of the Discharger to pay the specified ACL will be based on the Partnership's ability to generate income, and the amount of equity capital held by the Partnership. The principal data source for this analysis was the U.S. Return of Partnership Income, IRS Form 1065 for the five calendar years 2008 through 2012.

Income

The income statement is critical in assessing the profitability of the firm and trends in its performance over time. Table 1 presents the Discharger's income for the years 2008 through 2012. Farm and real estate income losses totaled $3,170,883 during that period. Income realized from capital gains (long-term capital gains and Section 1231 gains) totaled $1,553,729 during that period resulting in a total income loss of $1,620,452.

Table 1. Henry J. Tosta Jr. Family, L.P Dairy's Partner's Income Statements, 2008-2012.

	2012	2011	2010	2009	2008	Totals
Farm Income (Schedule F)	$ (466,332)	$ (331,037)	$ (307,532)	$(1,014,951)	$ (900,668)	$ (3,020,520)
Net Real Estate Income	$ (22,880)	$ (21,239)	$ (38,458)	$ (32,514)	$ (35,272)	$ (150,363)
Net Long-Term Capital Gain	$ 1,062,672	$ -	$ -	$ -	$ -	$ 1,062,672
Net Section 1231 Gain	$ -	$ 185,660	$ 125,979	$ 73,965	$ 105,453	$ 491,057
Other Expenses and (Income)	$ 884	$ 1,150	$ 227	$ 323	$ 714	$ 3,298
Net Income	**$ 572,576**	**$ (167,766)**	**$ (220,238)**	**$ (973,823)**	**$ (831,201)**	**$ (1,620,452)**

Source: Henry J. Tosta, Jr. Family, L.P., U.S. Return of Partnership Income, Form 1065. For calendar years 2008-2012.

The long-term capital and the Section 1231 gains itemized in the Table 1 require explanations to understand the income table. The Net Section 1231 gain reported for 2008 through 2011 represents sales or exchanges of property used in a trade or business and involuntary conversion that was held for more than one year. The property is described on IRS Form 4797 as raised livestock being over two years old. It is assumed these animals are replacement dairy heifers raised and sold by the Discharger so the capital gain is actually farm income.

The net long-term capital gain reported in 2012 is not itemized or described in the documentation submitted by the Discharger. Long-term capital gains are detailed on Form 8949 and the resulting gain (or loss) is transferred to Schedule D that summarizes all capital gains. Schedule D was included in the IRS income tax return submitted by the Discharger but Form 8949 was not. Therefore, it is not known if this represents the sale of livestock held for more than one year that would be similar to the Section 1231 capital gains or the sale of other productive assets. For the purposes of this analysis, it is assumed that the reported long-term capital gain represents the sale of farm animals held for more than one year.

The trend in annual income has improved from a negative income of $973,823 in the year 2009 to a positive income of $572,576 in 2012. The increasing income trend provides a solid foundation to pay the proposed ACL.

[3] Op. Cite., Page 19.

Cash Flow

Table 2 presents estimated cash flows for the five year period. The table is derived by adding back depreciation, amortization, depletion, and income not included in return to a firm's taxable income before net operating loss deductions. These expenses are added back because they do not represent actual cash transfers. This "pre-tax cash flow" shows the firm's historic pre-tax internally generated cash flows by year. The cash flow values represent cash generated by the firm after meeting all of its business expenses and is considered available to fund a penalty payment.

Table 2. Henry J. Tosta Jr. Family, L.P Dairy's Partner's Estimated Cash Flow Statements, 2008-2012.

	2012	2011	2010	2009	2008	Totals
Taxable Income Before NOL	572,576	(167,766)	(220,238)	(973,823)	(831,201)	$ (1,620,452)
Tax	-	-	-	-	-	$ -
Credit for Regulated Investment	-	-	-	-	-	$ -
Credit for Federal Fuels	-	-	-	-	-	$ -
Depreciation	78,673	96,396	246,491	407,555	415,326	$ 1,244,441
Depletion and Amortization	1,545	1,545	4,258	229	100	$ 7,677
Income Not Included on Return	-	-	-	-	-	$ -
Available After-Tax Cash Flow	**$ 652,794**	**$ (69,825)**	**$ 30,511**	**$ (566,039)**	**$ (415,775)**	**$ (368,334)**
Available Pre-Tax Cash Flow	**$ 652,794**	**$ (69,825)**	**$ 30,511**	**$ (566,039)**	**$ (415,775)**	**$ (368,334)**

Source: Henry J. Tosta, Jr. Family, L.P., U.S. Return of Partnership Income, Form 1065. For calendar years 2008-2012.

The Discharger deducted a total of $1,252,118 in depreciation and amortization during the five year period. Adding this amount to the taxable income yields the available pre-tax and after-tax cash flows for the reporting period. Since the Discharger passes tax responsibility to the partners, the total available cash flow for the five year reporting period was negative $368,334. This is substantially less than the total income of negative $1,620,452 (Table 1). The cash flow estimate provides a more accurate depiction of capital available to meet current expenses. The total available cash flow for 2012 of $652,794 is currently available for payment of the ACL.

Assets, Liabilities and Equity

The Balance Sheet contains information on assets, liabilities and the equity position of the partners (Table 3). Total assets of the Partnership decreased from $6,671,561 in 2008 to $5,988,932 in 2012. The $682,629 reduction represents a ten percent total reduction or an average annual reduction of two percent. The reduction in total assets from 2011 to 2012 was $120,872.

Buildings and land represent 91 percent of the Discharger's total assets and remained relatively stable over the reporting period. The reduction in the value of buildings is due to depreciation for tax purposes rather than an actual loss of market value.

Total liabilities increased from $4,163,411 in 2008 to $5,047,405 in 2011, a 21 percent increase or an average annual increase of 4.25 percent. However, total liabilities decreased by $691,417 from 2011 to 2012 as a result of the positive income earned in 2012.

The magnitude of changes in assets, liabilities and stockholder's equity relative to the income losses indicates the degree of financial strength remaining in the Partnership. As shown in the income statement (Table 1), total income losses of $1,620,452 were reported over the reporting period but total assets during the same period, declined by $682,629 and liabilities increased by $192,577. Income losses of this magnitude would normally be offset in subsequent years by increases in liabilities (loans), reductions in total assets, or a reduction in partner equity. The disparity between the magnitude of the income loss and the magnitude of the change in assets and liabilities begs the question that it appears the Partnership may be stronger financially than its loss of income makes it out to be.

Table 3. Henry J. Tosta Jr. Family, L.P Dairy's Partner's Balance Sheets, 2008-2012.

	2012	2011	2010	2009	2008
Assets					
Cash	-	102,893	91,249	-	-
Buildings	1,884,941	1,935,038	2,038,620	2,299,025	2,723,090
Land	3,591,282	3,591,282	3,591,282	3,591,282	3,591,282
Intangible Assets	33,866	35,411	36,956	41,214	2,813
Receivable - Banta Inn	201,713	201,174	188,376	158,376	158,376
Receivable - Lee Brown	277,130	244,006	211,740	201,800	196,000
Total Assets	**$ 5,988,932**	**$ 6,109,804**	**$ 6,158,223**	**$ 6,291,697**	**$ 6,671,561**
Liabilities					
Accounts Payable	-	-	-	-	-
Mortgages, Bonds Payable in <1 Year	736,964	1,341,279	1,043,875	795,825	2,010,200
Other Current Liabilities	76,817	41,483	64,327	62,613	56,991
Loans from Stockholders	93,447	-	-	-	-
Mortgages, Bonds Payable in >1 Year	3,448,760	3,664,643	3,799,126	3,943,391	2,096,220
Other Liabilities	-	-	-	-	-
Total Liabilities	**$ 4,355,988**	**$ 5,047,405**	**$ 4,907,328**	**$ 4,801,829**	**$ 4,163,411**
Stockholders' Equity	**$ 1,632,944**	**$ 1,062,399**	**$ 1,250,895**	**$ 1,489,868**	**$ 2,508,150**
Total Liabilities and Stockholders' Equity	**$ 5,988,932**	**$ 6,109,804**	**$ 6,158,223**	**$ 6,291,697**	**$ 6,671,561**

Source: Henry J. Tosta, Jr. Family, L.P., U.S. Return of Partnership Income, Form 1065. For calendar years 2008-2012.

Conclusion

Sufficient financial resources are available to the Discharger to pay the assessed ACL in the amount of $1,140,713 and remain in business. Net cash flow in 2012 was $652,794 and indicates a positive basis for the Discharger's future financial health. The Discharger's assets total $5,988,932 and net equity in the business operation is $1,632,944 that provides the Discharger with adequate means to pay or finance the proposed $1,140,713 ACL.