

Job Aid: Analyzing Income for the Self-Employed Borrower

When analyzing tax returns for qualifying income, you have 2 primary goals:

1. Understand the income trends of the borrower and determine if income is regular and recurring.
2. Address adjustments on the tax return that differentiate taxable income from qualifying income.

Key Adjustments	Underwriting Consideration
Business Use of Home	If the borrower is conducting business from the home, they are permitted to write off a portion of their home expense as a business expense and reduce their taxable income. Since we are already considering the borrower's housing debt, we would be double-counting this debt obligation if it was not added back to qualifying income.
Non Taxable Income	The IRS treats the income derived on key investments as non-taxable. While this income is not subject to income taxes, it is income available to the borrower and should be considered for qualifying. We add the non-taxable income back to qualifying income.
Non Recurring Income/Losses	Periodic income and/or losses should not be used in qualifying the borrower. Negating (or washing away) the income or loss is the goal when addressing non-recurring events. The borrower will not benefit from a one time gain in income, but they will also not be penalized by a one time loss event.
Guaranteed Payments	While some partnerships have guaranteed payment to partners, these payments can only be fulfilled if the partnership is financially successful. Confirming the profitability of the partnership is necessary before allowing guaranteed payments to be considered for qualifying income.
Depletion	Depletion is a "paper expense" - no actual dollars were spent although it is treated as an expense. We add this paper expense back to qualifying income.
Depreciation	Depreciation is a "paper expense" - no actual dollars were spent although it is treated as an expense. We add this paper expense back to qualifying income.

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Business Type	Documents to Request	Focus on 1040 Page 1 & 2 PLUS:	Key Income Adjustments	Risks to Look For:
Sole Proprietorship	1040	Schedule C	Business Use of Home Depreciation Depletion	<ul style="list-style-type: none"> ▪ Non-recurring other income or losses ▪ Reserves for self employment tax ▪ Accrual method accounting – distorts the borrower's cash flow and revenue
Partnership	1040 K1 1065	Schedule E K1 1065	Guaranteed Payments Non-recurring Income/Losses Depreciation Depletion	<ul style="list-style-type: none"> ▪ Non-recurring other income or losses ▪ Ability to sustain guaranteed payments ▪ Consistency of revenue and profitability ▪ Positive sale and earnings trend ▪ Liquidity to support income withdrawals
S Corporation	1040 K1 1120S	Schedule E K1 1120S	Non-recurring Income/Losses Depreciation Depletion	<ul style="list-style-type: none"> ▪ Non-recurring other income or losses ▪ Consistency of revenue and profitability ▪ Positive sales and earnings trend
Corporation	1040 W2 1120	Schedule B W2 1120	Non-recurring Income/Losses Depreciation Depletion	<ul style="list-style-type: none"> ▪ Non-recurring other income or losses ▪ Consistency of revenue and profitability ▪ Dividends paid to borrower ▪ Positive sales and earnings trend

THINGS TO REMEMBER:

1. Schedule C and the business tax returns: Look for declining income and a loss for the year. Were either of these negatives due to a one-time event or a recurring negative event, which may point to instability of the business.
2. Mortgages, Notes & Bonds payable in less than one year (Business tax returns): This is a large debt due and payable in the current fiscal year. This debt is usually subtracted from income unless documentation can be provided from the note holder that the debt will roll over or the business has sufficient liquidity to support payment.
3. Losses on tax returns need to be carefully reviewed to determine if the losses are recurring and, therefore, a drain on the borrower's income. Ask your borrower for the cause of any losses. Are they "paper" carryovers or losses due to a decline in the business.