Analyzing Business Tax Returns

SunTrust Mortgage

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<tr><td>Analyzing Partnership Returns for a Partnership or LLC</td><td>
Overview

Partnerships and some LLCs use IRS Form 1065 for filing informational federal income tax returns for the partnership or LLC. The partner’s or member-owner’s share of income (or loss) is carried over to IRS Form 1040, Schedule E.
A borrower with an ownership interest in a partnership or LLC may receive income in the form of wages or other compensation from the partnership or LLC in addition to the borrower’s proportionate share of income (or loss) reported on the Schedule K-1.

Evaluating the Business Income

When the borrower has 25% or more ownership interest in the business and business tax returns are required, the lender must perform a business cash flow analysis and evaluate the overall financial position of the borrower’s business to determine whether:

income is stable and consistent, and
sales and earnings trends are positive.

If the business does not meet these standards, business income cannot be used to qualify the borrower.

Borrower’s Proportionate Share of Income or Loss

The borrower’s proportionate share of income or loss is based on the borrower’s partnership percentage of Ending Capital in the business as shown on IRS Form 1065, Schedule K-1.
The lender can only consider the borrower’s proportionate share of the business income or loss after making the adjustments to the business cash flow analysis discussed below.

Adjustments to Business Cash Flow

Items that can be added back to the business cash flow include depreciation, depletion, amortization, casualty losses, and other losses that are not consistent and recurring.
The following items should be subtracted from the business cash flow:

meals and entertainment exclusion,
other reported income that is not consistent and recurring, and
the total amount of obligations on mortgages or notes that are payable in less than one year.

These adjustments are not required for lines of credit or if there is evidence that these obligations roll over regularly and/or the business has sufficient liquid assets to cover them.

Income from Partnerships, LLCs, Estates, and Trusts

Income from partnerships, LLCs, estates, or trusts can only be considered if the lender obtains documentation verifying that :

the borrower has ownership of the income (Schedule K-1 may be used to document ownership share), and
the income was actually distributed to the borrower.

Alternatively, the lender can obtain documentation verifying that:

the borrower has access to the income through a partnership agreement, LLC operating agreement, or other documentation that the lender determines is appropriate, unless the borrower(s) own 100% of the business in which case confirmation of access to the income is not required; and
the business has adequate liquidity to support the withdrawal of earnings.

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Topic	Information

Analyzing Returns for an S Corporation	**Overview**
	• S corporations and some LLCs pass gains and losses on to their shareholders, who are then taxed at the tax rates for individuals. S corporations and some LLCs use IRS Form 1120S, Schedule K-1, for filing federal income tax returns for the corporation. The shareholder's share of income or loss is carried over to IRS Form 1040, Schedule E. A borrower with an ownership interest in an S corporation or LLC may receive income in the form of wages or dividends in addition to his or her proportionate share of business income (or loss) reported on Schedule K-1.
	
	Evaluating the Business Income
	• When the borrower has 25% or more ownership interest in the business, the lender must perform a business cash flow analysis in order to evaluate the overall financial position of the business and confirm:
	    • the business income is stable and consistent, and
	    • the sales and earnings trends are positive.
	• If the business does not meet these standards, business income cannot be used to qualify the borrower.
	
	Borrower's Proportionate Share of Income or Loss
	• The borrower's proportionate share of income or loss is based on the borrower's (shareholder) percentage of stock ownership in the business for the tax year as shown on IRS Form 1120S, Schedule K-1. The cash flow analysis should consider only the borrower's proportionate share of the business income (or loss), taking into account any adjustments to the business income that are discussed below. Business income may only be used to qualify the borrower if the lender obtains documentation verifying that:
	    • the borrower has ownership of the income (Schedule K-1 may be used to document ownership share), and
	    • the income was actually distributed to the borrower.
	• Alternatively, the lender can obtain documentation verifying that:
	    • the borrower has access to the income through a corporate resolution or other documentation that the lender determines is appropriate—unless the borrower(s) own 100% of the business, in which case confirmation of access to the income is not required; and
	    • the business has adequate liquidity to support the withdrawal of earnings.
	
	Adjustments to Business Cash Flow
	• Items that can be added back to the business cash flow include depreciation, depletion, amortization, casualty losses, and other losses that are not consistent and recurring.
	• The following items should be subtracted from the business cash flow:
	    • meals and entertainment exclusion,
	    • other reported income that is not consistent and recurring, and
	    • the total amount of obligations on mortgages or notes that are payable in less than one year.
	• These adjustments are not required for lines of credit or if there is evidence that these obligations roll over regularly and/or the business has sufficient liquid assets to cover them.

Analyzing Business Tax Returns

Topic	Information

Analyzing Returns for a Corporation	**Overview**
	• Corporations use IRS Form 1120 to report their taxes.
	
	Corporate Fiscal Year
	• When funds from a corporation that operates on a fiscal year that is different from the calendar year are used in qualifying a self-employed borrower, the lender must make time adjustments to relate the corporate income to the borrower's individual tax return, which is on a calendar year basis.
	
	Determining the Corporation's Financial Position
	• After determining the income available to the borrower for qualifying purposes, the lender must evaluate the overall financial position of the corporation. Ordinary income from the corporation can be used to qualify the borrower only if the following requirements are met:
	    • the business income must be stable and consistent,
	    • the sales and earnings trends must be positive, and
	    • the business must have adequate liquidity to support the borrower's withdrawals of cash without having severe negative effects.
	
	Borrower's Share of Income or Loss
	• The cash flow analysis can only consider the borrower's share of the business income or loss, taking into consideration adjustments to business income provided below. Earnings may not be used unless the borrower owns 100% of the business.
	
	Adjustments to Cash Flow
	• Items that can be added back to the business cash flow include depreciation, depletion, amortization, casualty losses, net operating losses, and other special deductions that are not consistent and recurring.
	• The following items should be subtracted from the business cash flow:
	    • meals and entertainment exclusion,
	    • tax liability and amount of any dividends, and
	    • the total amount of obligations on mortgages or notes that are payable in less than one year.
	• These adjustments are not required if there is evidence that these obligations roll over regularly and/or the business has sufficient liquid assets to cover them.