Analyzing Individual Tax Returns

### General Information on Analyzing Individual Tax Returns
- In analyzing a self-employed borrower’s personal income, the lender should focus on earnings trends and the actual sources of the income, not just on the total amount of the income. The lender must confirm the stability and likelihood of continuance for each source of income that the borrower reports on his or her IRS Form 1040. The lender should not include any income that does not appear to be stable or likely to continue. The lender should, however, consider all recurring income that the borrower can expect to continue receiving over time.
- Income may be considered as recurring if the loan application package does not include any specific indication of an upcoming change in the borrower’s employment or income, the borrower’s employment history has no gaps or other significant fluctuations in income, and any income received under a contractual agreement (other than an “at will” contract) will continue to be received for at least three years.
- Examples of recurring income include:
  - regular salaries or wages,
  - bonus or commission income that has been received on a consistent basis,
  - interest income from long-term investments that are not being liquidated in connection with the mortgage transaction, and
  - earnings from the operation of the borrower’s business.
- Any nonrecurring loss (such as an extraordinary one-time expense) should not be included in the cash flow analysis; therefore, in developing the borrower’s qualifying income, the lender should adjust the borrower’s cash flow by the amount of any nonrecurring loss.

### Income Reported on IRS Form 1040

#### Overview
- To get an accurate picture of the borrower’s cash flow, the lender will need to make certain adjustments to some of the income (or loss) that the borrower reported on IRS Form 1040 since it may not be recurring income. The lender also may need to further analyze the accompanying tax schedules or supplemental tax forms.
- This section describes how the lender should treat various components of the income (or loss) that a self-employed borrower reported on IRS Form 1040 in its cash flow analysis.

**Note:** Eligibility criteria for accepting income from specific non-business sources is generally the same as that for salaried or commissioned borrowers.

#### Wages, Salary, and Tips
- If an amount is shown for wages, salary, or tips for a self-employed borrower, it may mean:
  - the borrower operates as a corporation and pays himself or herself a salary or
  - the borrower’s spouse is employed and receives a salary (either from the borrower’s business or from another employer).
- If the income relates to the borrower’s spouse who is employed by another company and the income will be used in qualifying for the mortgage, the spouse’s income must be verified directly with his or her employer since it may be more appropriate to use the spouse’s current earnings in underwriting the mortgage. Any income that is based on current earnings or that will not be used for qualifying purposes should be deducted from the borrower’s cash flow.

#### Interest and Dividend Income
- See the “Interest and Dividend Income” subtopic in Section 2.01: Agency Loan Programs of the Correspondent Seller Guide for guidance.

#### State and Local Tax Refunds
- Taxable state and local tax refunds, credits, or offsets of state and local income taxes should not be used as qualifying income since the income was accounted for in the previous year’s tax returns. Therefore, the borrower’s cash flow must be adjusted accordingly.

#### Alimony Received
- See the “Alimony, Child Support and/or Separate Maintenance Payments” subtopic in Section 2.01: Agency Loan Programs of the Correspondent Seller Guide for guidance.

#### IRA Distributions, Pensions and Annuities, and Social Security Benefits
- See the “Retirement, Government Annuity, and Pension Income” and “Tax Exempt Income” subtopics in Section 2.01: Agency Loan Programs of the Correspondent Seller Guide for guidance.
Analyzing Individual Tax Returns

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| Income Reported on IRS Form 1040, (continued) | Unemployment Compensation  
• Unemployment compensation may be considered as acceptable qualifying income if it meets the requirements described in the “Seasonal Income/Seasonal Unemployment Income” subtopic in Section 2.01: Agency Loan Programs of the Correspondent Seller Guide. Any reported unemployment compensation that is determined to be nonrecurring must be deducted from the borrower’s cash flow.   

Other Income (or Loss)  
• If the borrower reported income from other sources, the lender must verify that the income is an eligible source for qualifying purposes per the requirements for the applicable income source (as outlined in the Section 2.01: Agency Loan Programs of the Correspondent Seller Guide). Income that is determined to be nonrecurring or ineligible for qualifying purposes must be deducted from the borrower’s cash flow. If the borrower reported any nonrecurring losses, the borrower’s cash flow should be increased by the amount of the losses.  

Other Income (or Loss) from a Sole Proprietorship  
• The income (or loss) from a borrower’s sole proprietorship is calculated on IRS Form 1040, Schedule C, then transferred to IRS Form 1040.  
• The lender may need to make certain adjustments to the net profit or loss shown on Schedule C to arrive at the borrower’s cash flow. For example, Schedule C may include income that was not obtained from the profits of the borrower’s business. If the lender determines that such income is not recurring, it should adjust the borrower’s cash flow by deducting the nonrecurring income.  

Recurring vs. Non-recurring Income and Expenses  
• The lender must determine whether income is recurring or non-recurring.  
• Non-recurring income must be deducted in the cash flow analysis, including any exclusion for meals and entertainment expenses reported by the borrower on Schedule C.  
• The following recurring items claimed by the borrower on Schedule C must be added back to the cash flow analysis: depreciation, depletion, business use of a home, amortization, and casualty losses.  

Income or Loss Reported on IRS Form 1040, Schedule D  
Overview  
• IRS Form 1040, Schedule D, is used to report capital gains and losses. Income received from a capital gain is generally a one-time transaction; therefore, it should not usually be considered part of the borrower’s stable monthly income.  

Calculating Borrower Cash Flow from Schedule D and Required Documentation  
• If the income calculated on the Schedule D shows that the borrower has realized capital gains for the last two years, as may be the case when the borrower’s business has a constant turnover of assets that produces regular gains, the recurring gains can be considered in determining the borrower’s stable monthly income. In this case, the borrower must provide evidence of ownership of additional property or assets that can be sold if extra income is needed to make future mortgage payments.  
• The table below provides the requirements for calculating cash flow from Schedule D and the associated required documentation.  

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<th>If</th>
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<td>recurring capital gains relate to the sale of business property,</td>
<td>lenders must obtain a copy of the applicable Sale of Business Property (IRS Form 4797) to support the recurring nature of the capital gains.</td>
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</table>
| Schedule D includes principal payments on an installment sales contract, | lenders must obtain a copy of  
• the Installment Sale Income (IRS Form 6252), and  
• the note or contract to verify that the borrower will continue to receive the payments for at least three years. |
| the capital gain on the principal payment and interest income from an installment sales contract is determined to be nonrecurring, | the amount must be deducted from the borrower’s cash flow. |

Note: Capital losses identified on IRS Form 1040, Schedule D, do not have to be considered when calculating income or liabilities, even if the losses are recurring.
# Analyzing Individual Tax Returns

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| **Income or Loss Reported on IRS Form 1040, Schedule E** | **Overview**<br>• Income received from rents, royalties, and distributions from partnerships, corporations, estates, trusts, etc., is calculated on IRS Form 1040, Schedule E, and transferred to IRS Form 1040.<br>• Rather than using Schedule E for income related to distributions from partnerships, corporations, estates, and trusts, the lender should rely on Schedule K-1.  

**Royalty Income**<br>• Schedule E should be used to determine the supplemental income to use for royalties. The lender must include the total amount of royalty payments received, and must document the borrower’s receipt of royalty income for 12 months and the likelihood of continued receipt of such income for at least three years.<br>• See the “Royalty Payment Income” subtopic outlined in Section 2.01: Agency Loan Programs of the Correspondent Seller Guide for additional guidance.  

**Rental Income**<br>• If rental income is reported on Schedule E, only the rental income that relates to properties shown on the Schedule of Real Estate Owned on the borrower’s loan application should be included.<br>• All regular and ongoing expenses for the properties, such as maintenance, advertising, management fees, utilities, homeowners’ association dues, and supply costs, should be subtracted from the borrower’s cash flow.<br>• Depending on the approach used to calculate cash flow, adjustments will need to be made for depreciation and any one-time extraordinary expenses, such as the costs of repairing damage that resulted from a natural disaster.<br>• In most situations, the full amount of the mortgage payment for a rental property will be factored into the net rental income calculation, but it may also be counted as part of the liabilities that are considered in the calculation of the borrower’s total debt-to-income ratio. Therefore, the lender must add back any portion of the mortgage payment, including interest, taxes, and insurance, necessary to avoid double counting of these expenses.<br>• The lender must pay particular attention to the effect of “passive loss” limitations or prior “carryovers” related to the borrower’s rental properties and, depending on the method it uses for the cash flow analysis, make any special adjustments necessary to account for them.<br>• See the “Rental Income” subtopic outlined in Section 2.01: Agency Loan Programs of the Correspondent Seller Guide for additional guidance.  

**Income or Loss Reported on IRS Form 1040, Schedule F**<br>• See the “Farmland Income” subtopic outlined in Section 2.01: Agency Loan Programs of the Correspondent Seller Guide for guidance.  

**Income or Loss Reported on IRS Form 1065 or IRS Form 1120S, Schedule K-1**<br>• See “Schedule K-1 Income” in the “Self-Employment Income” subtopic outlined in Section 2.01: Agency Loan Programs of the Correspondent Seller Guide for guidance.  

**Documentation Requirements**<br>• The following table describes the documentation that the borrower must provide. The borrower must select one item from each row.  

<table>
<thead>
<tr>
<th>✓ Documentation Requirements</th>
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<tr>
<td>• the most recent two years of signed individual federal income tax returns—IRS Form 1040; or</td>
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<tr>
<td>• the most recent one year of signed individual federal income tax returns, if permitted by DU</td>
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<tr>
<td>• the most recent two years of IRS Schedule K-1; or</td>
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<tr>
<td>• the most recent year IRS Schedule K-1, if permitted by DU</td>
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<tr>
<td>• the most recent two years of business federal income tax returns (IRS Form 1065 or IRS Form 1120S), unless the requirements to waive business tax returns have been met; or</td>
</tr>
<tr>
<td>• the most recent one year of business federal income tax returns, if permitted by DU</td>
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