Partnerships, S Corporations, and Corporations

Whether or not additional income from a Partnership, S Corporation, or regular corporation is used to qualify an applicant, lenders must still conduct an analysis of the business tax returns to ensure a consistent pattern of profitability. Any loss resultin g from this anal ysis must be deducted from cash flow as it re presents a drain on the borrower's income.

The following sources of income may be considered for qualification provided:

- ☐ The borrower can document ownership and access to income.
- ☐ The business has adequate liquidity to support withdrawal of earnings; and
- ☐ The business has positive sales and earnings trends

Partnership (Form 1065)	Yr. ____	Yr. ____
40. Passthrough (Income) Loss from Other Partnerships – 4	(+/-)	(+/-)
41. Nonrecurring Other (Income) Loss – 7	(+/-)	(+/-)
42. Depreciation – 16c	(+)	(+)
43. Depletion – 17	(+)	(+)
44. Amortization/Casualty Loss – 20	(+)	(+)
45. Mortgage or Notes Payable in Less than 1 Year – 16	(-)	(-)
46. Meals and Entertainment Exclusion – M-1, line 4b	(-)	(-)
47. Subtotal		
48. Partnership Total (subtotal multiplied by % ownership)		

S Corporation (Form 1120S)		
49. Nonrecurring Other (Income) Loss – 5	(+/-)	(+/-)
50. Depreciation – 14c	(+)	(+)
51. Depletion – 15	(+)	(+)
52. Amortization/Casualty Loss – 19	(+)	(+)
53. Mortgage or Notes Payable in Less than 1 Year – 17	(-)	(-)
54. Meals and Entertainment Exclusion – M-1, 3b	(-)	( )
55. Subtotal		
56. S Corporation Total (subtotal multiplied by % ownership)		

Regular Corporation (Form 1120)		
57. Taxable Income – 30		
58. Total Tax – 31	(-)	( )
59. Nonrecurring (Gains) Losses – 9	(+/-)	(+/-)
60. Nonrecurring Other (Income) Loss – 10	(+/-)	(+/-)
61. Depreciation – 21b	(+)	(+)
62. Depletion – 22	(+)	(+)
63. Amortization/Casualty Loss – 26	(+)	(+)
64. Net Operating Loss and Special Deductions – 29c	(+)	(+)
65. Mortgage or Notes Payable in Less than 1 Year – 17	(-)	(-)
66. Meals and Entertainment Exclusion – M-1, 5c	(-)	(-)
67. Subtotal		
68 Subtotal Multiplied by Ownership Percentage		
69. Less: Dividends Paid to Borrower – Schedule B, line 6	(-)	(-)
70. Corporation Total		

÷12 for 1 yr.

Totals		
1040 total		
Partnership, S Corporation, and Corporation totals		
Grand Total		

Year-to-Date income from profit and loss statements may only be considered if it is consistent with the previous years' earnings. Allowable addbacks include depreciation, depletion, and other non-cash expenses as identified above.

Year-to-Date Profit and Loss Statement

Salary/Draw to Individual

Net Profit ________ X ________ %Ownership – ________

Total Allowable Addbacks ________ X ________ %Ownership – ________

Year-to-Date Total ________

CASH FLOW ANALYSIS (FORM 1084)

Form 1040 – Individual Income Tax Return

Line 1 - Total Income: Begin with Total Income, which represents the borrower's gross income before adjustments.

Line 2 – Wages, Salaries, Tips: Subtract any income reported on Form 1040 that has been verified and underwritten based on current information or that does not belong to the borrower. This type of income would include salary and hourly compensation, income from a spouse or ex-spouse that is not applying for mortgage credit, other income more appropriately underwritten based on current earnings rather than historical. Cross-reference the amount reported on Form 1040 against the amount indicated on the borrower's Form W-2.

Line 3 – Tax-exempt Interest Income: Add any tax-exempt interest income included on Form 1040 to the Total Income if it is likely to continue and is verified as recurring income. Taxable interest income and dividend income reported on Form 1040 will be addressed by analyzing Schedule B (Form 1040). This analysis should focus on the continuance of any interest or dividend income. (See analyzing Schedule B.)

Line 4 – State and Local Tax Refunds: Subtract from Total Income all taxable refunds, credits, or offsets of state and local income taxes reported on Form 1040. A tax refund cannot be included as qualifying income since it has been accounted for in the previous year's gross income.

Line 5 – Nonrecurring Alimony Received: Subtract from Total Income any alimony income that does not meet the following criteria:

- The receipt of alimony income has been documented as stable for at least 12 months,
- The payments will be on-going and consistent with the level reported on Form 1040 for a minimum of three years, and
- The alimony payments are made as a result of a divorce decree or written and signed agreement that is a legal obligation.

Line 6 – Negate Schedule D (Income) Loss: Examine Schedule D (Form 1040) to determine whether capital gains should be added to or whether capital losses should be subtracted from Total Income. (See analyzing Schedule D.)

Line 7 – Pension and/or IRA Distributions: The non-taxable portion of IRA distributions, pension, or annuity income is not included in Total Income reported on Form 1040. However, total distributions should be used as qualifying income provided the distributions are likely to continue for a minimum of three years and at their reported levels. Pension agreements or account verifications must be obtained to confirm the continuance of this income.

On Form 1040, total distributions are reported, however, only the taxable portion of total distributions is included in the borrower's Total Income. To determine the tax-

Unreimbursed employee expenses appear on Schedule A and indicate the borrower is subject to certain business expenses that must be factored in the analysis. The lender must obtain and examine Form 2106 if Schedule A indicates the presence of unreimbursed expenses.

Form 2106 - Employee Business Expenses

Line 13 – Total Expense: The borrower's unreimbursed expenses are reported on Form 2106. Subtract the reported amount from Total Income. Note that when the borrower recognizes "actual expenses" rather than using the "standard mileage rate," the lender must analyze the "actual expenses" section of the form checking for lease payments. Add back actual lease payments to ensure that the expense is recognized only once.

Line 14 – Depreciation: If the borrower has claimed automobile depreciation on Form 2106, this expense should be added to the borrower's income. Vehicle depreciation can be calculated one of two ways – by using the standard mileage deduction or actual depreciation expense. The method used by the borrower will be disclosed on the second page of Form 2106. If the borrower used the standard mileage deduction, multiply the business miles driven by the depreciation factor for the appropriate year and add the calculated amount to Total Income. If the borrower claimed the actual depreciation expense, add this amount to Total Income.

Schedule B (Form 1040) – Interest and Dividend Income

Line 15 – Nonrecurring Interest Income: Subtract nonrecurring interest income from Total Income. This includes interest income from assets used to complete the subject transaction. Document the existence of the accounts on which the interest is earned and confirm that the balances have not significantly decreased. Subtract any interest income from seller financed mortgages that have less than three years remaining in the contract or that is unstable because of delinquent repayment. (Note that the principal portion of installment payments received is reported in Schedule D and Form 6252 [*Installment Sale Income*])

Line 16 – Nonrecurring Dividend Income: Document that the assets producing dividend income exist and are owned by the borrower. Deduct nonrecurring dividend income from Total Income.

Schedule C (Form 1040) – Profit or Loss from Business: Sole Proprietorship

Line 17 – Nonrecurring Other (Income) Loss/Expense: Other income reported on Schedule C represents income received that was not obtained from the profits of the business. Unless this income is documented and determined to be stable, consistent, and recurring, subtract all Other Income.

Line 18 – Depletion: Add back to Total Income any depletion reported on Schedule C.

Line 19 – Depreciation: Add back to Total Income any depreciation reported on Schedule C. Vehicle depreciation can be calculated one of two ways – by using the standard mileage deduction or actual depreciation expense. If the borrower used the

Line 26 – Gross Rents and Royalties Received: Before analyzing the cash flow from rental properties, confirm that the borrower continues to own and rent all properties referenced in the schedule. Cross-reference the schedule of real estate owned as reported on the mortgage application with those listed in Schedule E and with mortgage obligations appearing on the credit report. Add on going gross rents received to Total Income.

If the borrower has listed royalty income, it should be verified as on going and consistent before including it as usable income. Add royalties received to the borrower's income when they are on going for three or more years.

Line 27 – Total Expenses before Depreciation: Subtract from gross rental income the total amount of expenses paid for property maintenance and upkeep. This includes all expenses reported on Schedule E except depreciation. The resulting calculation is the actual income from rental real estate activities.

Line 28 – Amortization/Casualty Loss/Nonrecurring Expenses: A borrower may occasionally claim amortization, casualty losses, or a one-time extraordinary expense, such as a new roof. When an amount is reported in Schedule E for these type expenses, add it back to Total Income.

Line 29 – Insurance, Mortgage Interest, and Taxes: Add back the insurance, mortgage interest, and tax expenses reported on Schedule E when using the full PITI payment for all rental property to calculate the borrower's qualifying ratios. Confirm that PITI payments include all elements – insurance, mortgage interest, and taxes.

The initial step to negate Schedule E income or loss cancelled out the effect of depreciation, depletion, and passive loss limitations on cash flow, therefore no adjustment is required for either of these items.

When using other cash flow worksheets that do not calculate actual losses, add depreciation and depletion expenses to the borrower's income. In addition, determine whether or not any properties were subject to passive loss limitations or used prior year unallowed losses. Prior year unallowed losses should be added back to cash flow and passive loss limitations should be subtracted. This step is not necessary, however, when using this worksheet.

Schedule F (Form 1040) – Profit or Loss from Farming

Line 30 – Non-taxable Portion Ongoing Coop and CCC Payments: Certain federal agriculture program payments, coop distributions, and insurance/loan proceeds are not fully taxable. Add the nontaxable portion of these income types to Total Income. However, caution should be exercised when including them. These sources of income may or may not be stable or continuous. Do not include any income that represents a one-time occurrence or is not stable.

Line 31 – Nonrecurring Other (Income) Loss: Other income reported on Schedule F represents income received by a farmer that was not obtained through farm operations. If this income can not be documented to be stable, consistent, and recurring, subtract Other Income and add Other Losses from income.

Line 39 – Net Income (Loss): Add continuous and on-going income to the borrower's income if the three conditions listed above are met and the income is not reported elsewhere in the borrower's tax returns. (Note that portfolio income, such as interest, dividends, and royalties, listed on Schedule K-1, is reported elsewhere on the 1040, therefore no adjustment is required.) Subtract on-going losses from the borrower's income.

Business Cash Flow: Partnerships, S Corporations, and Regular Corporations

The lender must analyze business tax returns to determine whether income from a Partnership, S Corporation, or Regular Corporation can be used to qualify the borrower. The business must show a consistent pattern of profitability for the income to be used. Losses identified by the lender's analysis must be deducted from the borrower's income since they represent a drain on cash flow.

Partnership – Form 1065

A partnership's distributive earnings and losses are reported on Form 1065 for informational purposes only. The partnership does not pay taxes. Any income or loss is passed through to the partners, with their distributive shares being reported on Schedule K-1 (Form 1065). The borrower's share of ordinary (net) income or loss from a partnership has already been addressed in the evaluation of Schedule K-1 (Form 1065). The analysis of Form 1065 will enable the lender to consider certain adjustments to the ordinary income or losses reported on Schedule K-1.

When analyzing Form 1065, only the partner's share of income or loss adjustments should be used to calculate income. The partner's share is based on his or her percentage of capital ownership as reported on the Schedule K-1. The worksheet provides for this calculation.

Line 40 - Passthrough (Income) Loss from Other Partnerships: Income and losses from these sources should generally not be recognized. In this case, the partnership is a partner in another partnership. Before any of this income can be used to qualify the borrower, additional documentation is needed to support distributions are being made to the borrower's partnership. In addition, the three conditions governing the use of K-1 income must be met relative to the partnership.

In general, subtract ordinary income from other partnerships and add any ordinary losses from other partnerships.

Line 41 - Nonrecurring Other (Income) Loss: Subtract other income or add other losses that are not consistent and recurring.

Line 42 - Depreciation: Add depreciation to income.

Line 43 - Depletion: Add depletion to income.

Line 44 - Amortization/Casualty Loss: Add amortization or casualty loss to income.

Line 54 - Meals and Entertainment Exclusion: Subtract the meals and entertainment exclusion reported on Schedule M-1 of Form 1120S from the business income.

Line 55 – Subtotal: Add/Subtract all amounts on lines 49 to 54 to determine the amount to be recorded on this line.

Line 56 - S Corporation Total: Multiply the subtotal (line 55) by the borrower's percentage of stock ownership, as reported on the Schedule K-1.

Corporation – Form 1120

Line 57 - Taxable Income: The analysis of corporate income begins with Taxable Income as reported on the first page of Form 1120. (Note: Corporate earnings may be used to qualify a borrower only when the borrower can document 100% ownership of the buisness.)

Line 58 - Total Tax: Corporations are required to pay taxes on earnings (unlike partnerships and S corporations). To determine the available cash flow from the business, subtract the corporation's tax liability from taxable income.

Line 59 - Nonrecurring (Gains) Losses: Determine the likelihood of continuance and stability of capital gains and net gains or losses reported on the first page of Form 1120. Subtract nonrecurring gains from the corporation's income and add nonrecurring losses.

Line 60 - Nonrecurring Other (Income) Loss: Subtract nonrecurring other income and add other nonrecurring losses.

Line 61 - Depreciation: Add corporate depreciation to income.

Line 62 - Depletion: Add corporate depletion to income.

Line 63 - Amortization/Casualty Loss: Add corporate amortization or casualty loss to income.

Line 64 - Net Operating Loss and Special Deductions: These deductions do not represent actual current expenses or losses. Therefore, add net operating loss and special deductions to the corporation's income.

Line 65 - Mortgage or Notes Payable in Less than 1 Year: These obligations may significantly affect the financial operations of the business. Subtract the amount of mortgage or note obligations payable in less than one year, as reported in Schedule L of Form 1120, end of year column.

If there is evidence that these liabilities regularly rollover and/or there are sufficient liquid business assets to cover them, no deduction is necessary.

Line 66 - Meals and Entertainment Exclusion: Subtract the meals and entertainment exclusion reported on Schedule M-1 of Form 1120 from the business income.

Job Aid

FannieMae.

Cash Flow Analysis

Borrower Name: ____________________

The following self-employed income analysis worksheet and accompanying guidelines generally apply to individuals:

☐ Who have 25% or greater interest in a business ☐ Who are employed by family members ☐ Who are paid commissions ☐ Who own rental property
☐ Who receive variable income, have earnings reported on IRS Form 1099, or income that cannot otherwise be verified by an independent and knowable source.

ex. [illegible] OR [illegible] a loss [illegible]

analyze Schedule C [illegible]

	Yr. ____	Yr. ____
Form 1040 Individual Income Tax Return		
1. Total Income – 22	____	____
2. Wages, salaries considered elsewhere – W2	(-)	(-)
3. Tax-Exempt Interest Income – 8b	(+)	(+)
4. State and Local Tax Refunds – 10	(-)	(-)
5. Nonrecurring Alimony Received – 11	(-)	(-)
6. Negate Schedule D (Income) Loss – 13	(+/-)	(+/-)
7. Pension and/or IRA Distributions – 15 & 16	(+)	(+)
8. Negate Schedule E (Income) Loss – 17	(+/-)	(+/-)
9. Nonrecurring Unemployment Compensation – 19	(-)	(-)
10. Social Security Benefit – 20	(+)	(+)
11. Nonrecurring Other (Income) Loss – 21	(+/-)	(+/-)
12. Other [illegible] recap	____	____
Form 2106 Employee Business Expenses		
13. Total Expenses – 8	(-)	(-)
14. Depreciation – 22 & 28	(+)	(+)
Schedule B Interest and Dividend Income		
15. Nonrecurring Interest Income – 2	(-)	(-)
16. Nonrecurring Dividend Income – 6	(-)	(-)
Schedule C Profit or Loss from Business: Sole Proprietorship		
17. Nonrecurring Other (Income) Loss/Expenses – 6	(+/-)	(+/-)
18. Depletion – 12	(+)	(+)
19. Depreciation – 13	(+)	(+)
20. Meals and Entertainment Exclusion – 24c	(-)	(-)
21. Business Use of Home – 30	(+)	(+)
22. Amortization/Casualty Loss – Part V	(+)	(+)
Schedule D Capital Gains and Losses		
23. Recurring Capital Gains/(Loss) – 7 & 16	(+/-)	(+/-)
Form 4797 Sales of Business Property		
24. Recurring Capital Gains/(Loss) – 11 & 12	(+/-)	(+/-)
Form 6252 Installment Sale Income		
25. Principal Payments Received – 21	(+)	(+)
Schedule E Supplemental Income and Loss		
26. Gross Rents and Royalties Received – 3 & 4	(+)	(+)
27. Total Expenses Before Depreciation – 19	(-)	(-)
28. Amortization/Casualty Loss/Non-recurring Expenses – 18	(+)	(+)
29. Insurance, Mortgage Interest, and Taxes included in PITI payment – 9, 12 & 16 (Only if using the property's full PITI payment in qualifying ratios)	(+)	(+)
Schedule F Profit or Loss from Farming		
30. Non-Tax Portion Ongoing Coop and CCC Payments – 5, 6, 7 & 8	(+)	(+)
31. Nonrecurring Other (Income) Loss – 10	(+/-)	(+/-)
32. Depreciation – 16	(+)	(+)
33. Amortization/Casualty Loss/Depletion – 34	(+)	(+)
34. Business Use of Home – 34	(+)	(+)

(Consider K-1 income only if the borrower can document ownership and access to income, the business has adequate liquidity to support withdrawal, and the business has positive sales and earnings trends.)

Partnership Schedule K-1 (Form 1065)		
35. Ordinary Income (Loss) – 1	(+/-)	(+/-)
36. Net Income (Loss) – 2 & 3	(+/-)	(+/-)
37. Guaranteed Payments to Partner – 5	(+)	(+)
S Corporation Schedule K-1 (Form 1120s)		
38. Ordinary Income (Loss) – 1	(+/-)	(+/-)
39. Net Income (Loss) – 2 & 3	(+/-)	(+/-)
1040 Total		

*25% or more owner of a company you [illegible] have these tax returns

CASH FLOW ANALYSIS (FORM 1084)

Form 1040 – Individual Income Tax Return

Line 1 - Total Income: Begin with Total Income, which represents the borrower's gross income before adjustments.

Line 2 – Wages, Salaries, Tips: Subtract any income reported on Form 1040 that has been verified and underwritten based on current information or that does not belong to the borrower. This type of income would include salary and hourly compensation, income from a spouse or ex-spouse that is not applying for mortgage credit, other income more appropriately underwritten based on current earnings rather than historical. Cross-reference the amount reported on Form 1040 against the amount indicated on the borrower's Form W-2.

Line 3 – Tax-exempt Interest Income: Add any tax-exempt interest income included on Form 1040 to the Total Income if it is likely to continue and is verified as recurring income. Taxable interest income and dividend income reported on Form 1040 will be addressed by analyzing Schedule B (Form 1040). This analysis should focus on the continuance of any interest or dividend income. (See analyzing Schedule B.)

Line 4 – State and Local Tax Refunds: Subtract from Total Income all taxable refunds, credits, or offsets of state and local income taxes reported on Form 1040. A tax refund cannot be included as qualifying income since it has been accounted for in the previous year's gross income.

Line 5 – Nonrecurring Alimony Received: Subtract from Total Income any alimony income that does not meet the following criteria:

- The receipt of alimony income has been documented as stable for at least 12 months,
- The payments will be on-going and consistent with the level reported on Form 1040 for a minimum of three years, and
- The alimony payments are made as a result of a divorce decree or written and signed agreement that is a legal obligation.

Line 6 – Negate Schedule D (Income) Loss: Examine Schedule D (Form 1040) to determine whether capital gains should be added to or whether capital losses should be subtracted from Total Income. (See analyzing Schedule D.)

Line 7 – Pension and/or IRA Distributions: The non-taxable portion of IRA distributions, pension, or annuity income is not included in Total Income reported on Form 1040. However, total distributions should be used as qualifying income provided the distributions are likely to continue for a minimum of three years and at their reported levels. Pension agreements or account verifications must be obtained to confirm the continuance of this income.

On Form 1040, total distributions are reported, however, only the taxable portion of total distributions is included in the borrower's Total Income. To determine the tax-

Unreimbursed employee expenses appear on Schedule A and indicate the borrower is subject to certain business expenses that must be factored in the analysis. The lender must obtain and examine Form 2106 if Schedule A indicates the presence of unreimbursed expenses.

Form 2106 - Employee Business Expenses

Line 13 – Total Expense: The borrower's unreimbursed expenses are reported on Form 2106. Subtract the reported amount from Total Income. Note that when the borrower recognizes "actual expenses" rather than using the "standard mileage rate," the lender must analyze the "actual expenses" section of the form checking for lease payments. Add back actual lease payments to ensure that the expense is recognized only once.

Line 14 – Depreciation: If the borrower has claimed automobile depreciation on Form 2106, this expense should be added to the borrower's income. Vehicle depreciation can be calculated one of two ways – by using the standard mileage deduction or actual depreciation expense. The method used by the borrower will be disclosed on the second page of Form 2106. If the borrower used the standard mileage deduction, multiply the business miles driven by the depreciation factor for the appropriate year and add the calculated amount to Total Income. If the borrower claimed the actual depreciation expense, add this amount to Total Income.

Schedule B (Form 1040) – Interest and Dividend Income

Line 15 – Nonrecurring Interest Income: Subtract nonrecurring interest income from Total Income. This includes interest income from assets used to complete the subject transaction. Document the existence of the accounts on which the interest is earned and confirm that the balances have not significantly decreased. Subtract any interest income from seller financed mortgages that have less than three years remaining in the contract or that is unstable because of delinquent repayment. (Note that the principal portion of installment payments received is reported in Schedule D and Form 6252 [*Installment Sale Income*])

Line 16 – Nonrecurring Dividend Income: Document that the assets producing dividend income exist and are owned by the borrower. Deduct nonrecurring dividend income from Total Income.

Schedule C (Form 1040) – Profit or Loss from Business: Sole Proprietorship

Line 17 – Nonrecurring Other (Income) Loss/Expense: Other income reported on Schedule C represents income received that was not obtained from the profits of the business. Unless this income is documented and determined to be stable, consistent, and recurring, subtract all Other Income.

Line 18 – Depletion: Add back to Total Income any depletion reported on Schedule C.

Line 19 – Depreciation: Add back to Total Income any depreciation reported on Schedule C. Vehicle depreciation can be calculated one of two ways – by using the standard mileage deduction or actual depreciation expense. If the borrower used the

Line 26 – Gross Rents and Royalties Received: Before analyzing the cash flow from rental properties, confirm that the borrower continues to own and rent all properties referenced in the schedule. Cross-reference the schedule of real estate owned as reported on the mortgage application with those listed in Schedule E and with mortgage obligations appearing on the credit report. Add on going gross rents received to Total Income.

If the borrower has listed royalty income, it should be verified as on going and consistent before including it as usable income. Add royalties received to the borrower's income when they are on going for three or more years.

Line 27 – Total Expenses before Depreciation: Subtract from gross rental income the total amount of expenses paid for property maintenance and upkeep. This includes all expenses reported on Schedule E except depreciation. The resulting calculation is the actual income from rental real estate activities.

Line 28 – Amortization/Casualty Loss/Nonrecurring Expenses: A borrower may occasionally claim amortization, casualty losses, or a one-time extraordinary expense, such as a new roof. When an amount is reported in Schedule E for these type expenses, add it back to Total Income.

Line 29 – Insurance, Mortgage Interest, and Taxes: Add back the insurance, mortgage interest, and tax expenses reported on Schedule E when using the full PITI payment for all rental property to calculate the borrower's qualifying ratios. Confirm that PITI payments include all elements – insurance, mortgage interest, and taxes.

The initial step to negate Schedule E income or loss cancelled out the effect of depreciation, depletion, and passive loss limitations on cash flow, therefore no adjustment is required for either of these items.

When using other cash flow worksheets that do not calculate actual losses, add depreciation and depletion expenses to the borrower's income. In addition, determine whether or not any properties were subject to passive loss limitations or used prior year unallowed losses. Prior year unallowed losses should be added back to cash flow and passive loss limitations should be subtracted. This step is not necessary, however, when using this worksheet.

Schedule F (Form 1040) – Profit or Loss from Farming

Line 30 – Non-taxable Portion Ongoing Coop and CCC Payments: Certain federal agriculture program payments, coop distributions, and insurance/loan proceeds are not fully taxable. Add the nontaxable portion of these income types to Total Income. However, caution should be exercised when including them. These sources of income may or may not be stable or continuous. Do not include any income that represents a one-time occurrence or is not stable.

Line 31 – Nonrecurring Other (Income) Loss: Other income reported on Schedule F represents income received by a farmer that was not obtained through farm operations. If this income can not be documented to be stable, consistent, and recurring, subtract Other Income and add Other Losses from income.

Line 39 – Net Income (Loss): Add continuous and on-going income to the borrower's income if the three conditions listed above are met and the income is not reported elsewhere in the borrower's tax returns. (Note that portfolio income, such as interest, dividends, and royalties, listed on Schedule K-1, is reported elsewhere on the 1040, therefore no adjustment is required.) Subtract on-going losses from the borrower's income.

Business Cash Flow: Partnerships, S Corporations, and Regular Corporations

The lender must analyze business tax returns to determine whether income from a Partnership, S Corporation, or Regular Corporation can be used to qualify the borrower. The business must show a consistent pattern of profitability for the income to be used. Losses identified by the lender's analysis must be deducted from the borrower's income since they represent a drain on cash flow.

Partnership – Form 1065

A partnership's distributive earnings and losses are reported on Form 1065 for informational purposes only. The partnership does not pay taxes. Any income or loss is passed through to the partners, with their distributive shares being reported on Schedule K-1 (Form 1065). The borrower's share of ordinary (net) income or loss from a partnership has already been addressed in the evaluation of Schedule K-1 (Form 1065). The analysis of Form 1065 will enable the lender to consider certain adjustments to the ordinary income or losses reported on Schedule K-1.

When analyzing Form 1065, only the partner's share of income or loss adjustments should be used to calculate income. The partner's share is based on his or her percentage of capital ownership as reported on the Schedule K-1. The worksheet provides for this calculation.

Line 40 - Passthrough (Income) Loss from Other Partnerships: Income and losses from these sources should generally not be recognized. In this case, the partnership is a partner in another partnership. Before any of this income can be used to qualify the borrower, additional documentation is needed to support distributions are being made to the borrower's partnership. In addition, the three conditions governing the use of K-1 income must be met relative to the partnership.

In general, subtract ordinary income from other partnerships and add any ordinary losses from other partnerships.

Line 41 - Nonrecurring Other (Income) Loss: Subtract other income or add other losses that are not consistent and recurring.

Line 42 - Depreciation: Add depreciation to income.

Line 43 - Depletion: Add depletion to income.

Line 44 - Amortization/Casualty Loss: Add amortization or casualty loss to income.

Line 67 – Subtotal: Add/Subtract all amounts on lines 57 to 66 to determine the amount to be recorded on this line.

Line 68 - Subtotal Multiplied by Ownership Percentage: Multiply the subtotal (line 67) by the borrower's percentage of stock ownership, as reported on the Schedule E (Form 1120) or other independent source. (This must be 100%.)

Line 69 - Less: Dividends Paid to Borrower: Distributions (dividends) paid to stockholders are reported on Schedule M-2 of Form 1120. The borrower's share of these distributions will be reported on Schedule B (Form 1040). These funds are also included in the corporation's taxable income and are therefore being double counted. Therefore, subtract distributions paid by the corporation and reported on the borrower's Schedule B (Form 1040).

Line 70 - Corporation Total: Line 68 less line 69 equals total corporation income.

Year-to-date Income Analysis

Year-to-date income from profit and loss statements may only be considered if the income and expenses are consistent with the previous year's performance. Any salaries or draws received by the borrower, as well as any adjustments used when analyzing tax returns, such as nonrecurring income and expenses, depreciation, and depletion, may be added to the business cash flow. Note, however, that these adjustments are limited to the borrower's proportionate share of ownership of the business.