



Once you've used PROFITability®,  
you'll definitely understand the connection.  
[www.profitstars.com](http://www.profitstars.com)



HOME | ABOUT US | ADVERTISE | CLASSIFIEDS | RESOURCES | RESEARCH | SUBSCRIBE

LENDING

MARKETING

TECHNOLOGY

OPERATIONS

HUMAN RESOURCES

COMMUNITY SERVICE

CU DATA

PRODUCTS

BUYERS' GUIDE

INFO SYSTEMS GUIDE

#### INSTANT POLL

**What's the best way to help members in financial crisis?**

- Extend loan terms and/or lower rates
- Require credit counseling
- Second-chance checking and other programs
- Ongoing member education

Send

SIGN UP TODAY FOR  
**TOC ALERT**  
AND  
**TOP TEN**  
NEWS & VIEWS



## How to Underwrite Self-Employed Borrowers

By Tim Harrington

Self-employed borrowers are among the most difficult for loan officers to underwrite. Why? Obtaining a reliable estimate of such borrowers' earnings from their tax returns can be confusing, even deceiving.

Many loan officers I speak to simply find the borrower's adjusted gross income and divide that amount by 12 to estimate a monthly income.

Sometimes this amount is reliable—but even a broken watch is accurate twice a day. Therefore, if loan officers get the correct income it's just by coincidence.

It's better for loan officers to carefully analyze that borrower's tax return and find as much useful information regarding the borrower's real **cash flow** as possible. Cash flow is what borrowers use to pay you back, not taxable income.

Unfortunately, the IRS didn't design tax returns to provide a clear picture of cash flow. Tax returns are designed to report taxable income and deductible expenses.

But not all taxable incomes are real "positive cash flows." Many borrowers receive income that isn't reported as taxable income. To make it more confusing, some borrowers pay taxes on income they didn't receive that tax year.

On the other hand, several deductible expenses reduce taxable income but are phantom expenses, meaning they created a tax benefit that lowered income but didn't result from cash outflow during that year.

SEARCH

at a Bright Idea  
inspired with these colorful pro  
ugh July 1, 2008!

at 800.248.6343 to place your or



And finally, there are real tax losses or expenses that took money out of your borrower's pocket that weren't allowed as deductible expenses on the tax return. From this confusing milieu we attempt to derive a useful estimate of a borrower's real cash flow.

Keep the following in mind when looking at a borrower's tax return to verify income for a consumer loan or mortgage:

**Get a complete copy of the Federal Form 1040.** The [Form 1040](#) is key to identifying the different kinds of income a borrower earns. Borrowers often will want to give you only page one of the 1040 and some other schedule. They tend to be reluctant to provide the whole return. But ask for the whole return. Chances are, having the whole return will allow you to pick up more income for the borrower.

**Only consider recurring income.** Keep in mind that you're using old, historical information—a tax return from a previous year—to calculate cash flow. But the borrower will pay you back in the future. Just because the borrower reported income in a prior tax year doesn't mean the person still receives that income. Look at the tax return for evidence of income that will likely be around in the future. Or, in other words, that are "recurring."

**Obtain returns for the past two years.** While wages tend to be stable, nonwage income and self-employed income can fluctuate wildly from year to year. A loan officer wants an idea of an average income.

Furthermore, if someone is self-employed, you want to know that their business has been around for a few years. New businesses have high failure rates. But if they last a few years, they're more likely to be around in the future.

### **Helpful forms and schedules**

Listed below are some useful tax forms and schedules, and suggestions for obtaining useful and accurate cash flow information from the particular form or schedule:

**Form 1040, page one.** Page one reports several forms of nontaxable income. If these are recurring, they can be added to the borrower's income. Look for tax-exempt interest income, and to see if there's any individual retirement account, pension, or Social Security income that was received but not taxed. You would know this if the amount in the "a" column was greater than the amount in the "b" column. The difference would be added to the borrower's income.

**Schedule B:** Income from interest and dividends. Your main concern here is whether the income is recurring. This schedule identifies where interest and dividend income comes from. You want to know if those sources will generate income in the future. If not, remove it from consideration.

**Schedule C:** Profit or loss from sole proprietorship. Look for depreciation and depletion. These items are expenses that reduce taxable income. But they are "phantom" expenses; no cash left the borrower's hands. Add back all depreciation and depletion.

**Schedule D:** Gains or losses on sales. Gains or losses on sales of assets are usually one-time occurrences. Include the gains or losses from the schedule if the borrower shows a history of gains or losses. If not, they're not 'recurring' and should be disregarded.

**Schedule E, page one:** Rental and royalty income. One major item is depreciation. Add this back.

**Schedule E, page two:** Partnership and S corporation income or loss. This is where an owner of a partnership or S corporation reports the business profit or loss. These are "pass-through" businesses that don't pay taxes directly. The business' income is passed through to the owners' tax return.

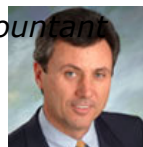
The owner, not the business, pays the taxes. Therefore, the information reported on page two usually doesn't represent the true cash flow the borrower received from this business. Your credit union gets paid from real cash flow. Therefore, for lending purposes, you should disregard most of the income or loss reported on page two. Instead:

**If it's a partnership**, ask the borrower for [Schedule K-1](#). At line N, look for withdrawals or distributions. This is the amount of cash the borrower took out of a partnership. This is the qualifying income you'd like to use.

**If it's an S corporation** (which also has a K-1, which isn't helpful to us), ask how much cash the borrower took out of the corporation in the form of dividends. If the borrower can prove having received the dividends, use it as qualifying income. If not, disregard it.

While this article doesn't provide complete information on obtaining cash flow from a tax return, it will help you with common, simple returns. This is a complex area. Having a good understanding is difficult to obtain, but important for good underwriting.

*[Tim Harrington](#) is a certified public accountant specializing in credit unions and president of [TEAM Resources](#), Tucson, Ariz. Contact him at 800-788-9542.*



## Resources

- [Using Tax Returns to Qualify a Loan eSchool](#), Feb. 7-21
- [Lenders Tax Analyzer](#)

Copyright © 2008 - Credit Union National Association, Inc.