

Analysis of a Business Owner's Personal Tax Returns



Training Materials Prepared by the :



and its

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Section 1-Overview

Income Calculation Methods:

This training material is based on the Schedule Analysis Method of income calculation. The Schedule Analysis Method largely considers only direct income from the appropriate schedules C, E, and F and K-1's. This method is more conservative and therefore used throughout this manual. In order to include income and losses other those reported on the appropriate schedules, it must be "regular and recurring".

"Regular and recurring" is defined in this manual as income or losses having been reported at least 3 consecutive years and is verifiable. (See Page 15 for further details)

Note: The methods of analyzing a sole proprietor as detailed in this manual are not necessarily the methods of analysis used or recommended by Fannie Mae, Freddie Mae, GE or any other similar entity. The methods contained in this manual are "best practice" conservative methods.

Evaluation Considerations:

Self employed borrowers in general tend to be higher risk borrowers because of the following factors:

1. Lack of Industry Experience
2. Lack of Business Management Experience
3. Businesses Tend to Be Cyclical (Landscaper, Construction Worker)
4. Business Plan Lacks Feasibility
5. Products or Services Fill a Limited Need in The Marketplace
6. Personal Credit Is Reflective of Bad Habits Which Carry Over to Business Environment
7. Lack of Personal Reserves or Savings to Support Business During Slow Times
8. Lack of Viable Collateral

Necessary Form 1040 Adjustments:

Deductions versus Cash-Out Expenses:

When calculating repayment ability of your borrower, Cash Generation or Cash Flow should always be your primary concern. Therefore, deductions allowed for tax preparation purposes by the IRS are typically omitted from this method of income calculation. Cash-out expenses, however are always considered.

Pass-Thru Income and Losses versus Actual Cash-In or Cash-Out Received:

S-Corporations and Partnerships do not pay taxes directly to the IRS. Instead, taxable income or losses are passed through to the owners of these entities via Schedule K-1's to the owners 1040 where the income or losses are reported and taxes are assessed. Therefore, pass-through income or losses for tax purposes are not considered Cash Generation or Cash Flow items.

Regular and Recurring Adjustments:

Regular and recurring is defined in this manual as income or losses having been reported at least 3 consecutive years and are verifiable. The following are specific examples of

- W-2 Wages would be an example of an item that maybe regular and recurring if the three year criteria have been met and the prospective borrower intends to remain employed in the same capacity as the tax returns indicate; if not, an adjustment will need to be made to remove W-2 wages from consideration.

Reduction of Income equal to any W-2 Wage Income that has not been or will now longer be "Regular and Recurring: \$ _____

- Tax Refunds are examples of items that may not be regular and recurring. The most conservative underwriting standards require that tax refunds not be considered as income; therefore an adjustment is necessary to remove this from consideration.

Reduction of Income equal to any Tax Refunds: \$ _____

- Pension Plan distributions or disbursements are items that may be regular and recurring. Further investigation in the likelihood of continuation of the distributions will need to be made.

Reduction of Income equal to any Pension Plan Distributions which are Not Regular and Recurring: \$ _____

- Capital Gains or Losses are items that may be regular and recurring. Also Capital Gains or Losses should not be fully considered "Cash" Items unless purchase and sale occurs in same year.

Reduction of Income equal to any Capital Gains or Losses which are Not Regular and Recurring: \$ _____

S-Corporation Owner's Worksheet

Individual Tax Return (**Form 1040**)

200

200

200

Personal Income Section:

1. Wages (<i>Line 7</i>)	(+) _____	_____	_____
2. Less Wages included in (<i>Line 7</i>) from spouse not considered as co-borrower in loan request	(-) _____	_____	_____
3. Taxable Interest Income (<i>Line 8a</i>)	(+) _____	_____	_____
4. Non Taxable Interest Income (<i>Line 8b</i>)	(+) _____	_____	_____
5. Less any interest earned by businesses owned-as identified on Schedule B carried over from Schedule K-1	(-) _____	_____	_____
6. Ordinary Dividend Income (<i>Line 9a</i>)	(+) _____	_____	_____
7. Less any dividends earned by businesses owned-as identified on Schedule B carried over from Schedule K-1	(-) _____	_____	_____
8. Qualified Dividends (<i>Line 9b</i>)	(+) _____	_____	_____
9. Tax refunds, credits, offsets of state or local taxes (<i>Line 10</i>)	_____	_____	_____
10. Alimony received	(+) _____	_____	_____
11. Business income and loss Schedule C (<i>Line 12</i>) (<i>See Below</i>)	_____	_____	_____
12. Capital Gains or Losses (<i>Line 13</i>)*	(+) or (-) _____	_____	_____
13. Other gains or losses (<i>Line 14</i>)	(+) or (-) _____	_____	_____
14. IRA Distributions (<i>Line 15</i>)	(+) _____	_____	_____
15. Pensions and Annuities (<i>Line 16</i>)	(+) _____	_____	_____
16. Rental Real Estate, et al, Schedule E (<i>Line 17</i>) (<i>See Below</i>)	_____	_____	_____
17. Unemployment Compensation (<i>Line 19</i>)	(+) _____	_____	_____
18. Farm income, Schedule F (<i>Line 18</i>) (<i>Use Sched. C Below</i>)	_____	_____	_____
19. Social Security Benefits (<i>Line 20a</i>)	(+) _____	_____	_____
20. Other Income (<i>Line 21</i>)	(+) _____	_____	_____
21. Plus any Distributions Paid by Companies Owned Listed on Schedule K-1	(+) _____	_____	_____
22. Plus any Guaranteed Pymts to Partners Listed on Sched. K-1	(+) _____	_____	_____
23. Personal Income Total (Sum of Items 1-22)	_____	_____	_____

Schedule C Business Income Section:

24. Gross Receipts or Sales (<i>Line 1</i>)	(+) _____	_____	_____
25. Less Returns and Allowances (<i>Line 2</i>)	(-) _____	_____	_____
26. Less Cost of Goods Sold (COGS) (<i>Line 4</i>)	(-) _____	_____	_____
27. Other Income (<i>Line 6</i>)	(+) _____	_____	_____
28. Expenses (<i>Line 28</i>)	(-) _____	_____	_____
29. Plus Mortgage Interest (<i>Line 16a</i>)**	(+) _____	_____	_____
30. Plus Other Interest (<i>Line 16b</i>)**	(+) _____	_____	_____
31. Plus Depletion (<i>Line 12</i>)**	(+) _____	_____	_____
32. Plus Depreciation (<i>Line 13</i>)**	(+) _____	_____	_____
33. Less Other Expenses Not Included on Return (<i>Schedule C Page 2 Part V</i>)	(-) _____	_____	_____
34. Schedule C Business Income Total (Sum of Items 24-33)	_____	_____	_____

Schedule E (Part 1 Only) Supplemental Income and Loss Section:

35. Gross rents Received (Line 3 -Totals Column) (+) _____
36. Royalties Received (Line 4-Totals Column) (+) _____
37. Expenses (Line 19) (-) _____
38. Plus Mortgage Interest (Line 12)** (+) _____
39. Plus Other Interest (Line 13)** (+) _____
--Skip Line 20--

40. Schedule E Part 1 Only Supplemental Income and Loss
(Sum of Items 35-39) _____

Income Section Summary:

41. Personal Income Total (Line 23 above) _____
42. Schedule C Business Income Total (Line 34 above) _____
43. Schedule E Part 1 Only Supplemental Income and Loss (Line 40 above) _____

44. Total Income (Sum of Lines 41-43 above) _____

45. Less Taxes Paid (Line 63) (-) _____

46. Total Income After Taxes (Total Line 44 Less Line 45) _____
(a/k/a known as Cash Available for Debt Service and Living Expenses)

Debt Service Requirements: (Obtain from Credit Bureau Reports, Personal Financial Statements and Application)

47. Total Mortgage Loan Payments (Business & Personal) (+) _____
48. Total Term Loan Payments (Business & Personal) (+) _____
49. Total Vehicle Loan Payments (Business & Personal) (+) _____
50. Total Line of Credit Payments (As if Fully Funded Yearly) (+) _____
51. Total Credit Card Payments (Actual Business & Personal) (+) _____

52. Total Current Debt Service Requirements: (Sum of Lines 47-51) _____

53. Proposed Business Loan Payment (\$ /Mo) (+) _____

54. Total Current & Proposed Debt Service Requirements (52+53) _____

Cash After Debt Service (CADS):

55. Cash Excess/Deficit (Line 46 Less 54) _____
(Compare number of Dependents list on Line 6c)

Debt Servicing Ability:

56. Debt Service Coverage Ratio (DSCR): (Line 46 divided by Line 54) _____:1 _____:1 _____:1

57. Debt To Income Ratio (DTI): (Line 54 divided by Line 46) _____

Footnotes:

*Consider only if Regular and Recurring

**Added back: Depreciation is a non-cash expense; interest expense will be considered in Debt Service Requirement