

## **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-

exempt portion of this income, calculate the difference between total distributions and the taxable portion and add the difference to Total Income by recording the calculated amount on Line 7 of our form. The tax-exempt portion of this income can be grossed up according to the guidelines that address tax-exempt income.

**Line 8 – Negate Schedule E (Income) Loss:** Negate all income (subtract) or loss (add) from rental real estate, royalties, partnerships, S corporations, and trusts. Each component of Schedule E (Form 1040) income (loss) reported on the first page of Form 1040 will be analyzed separately. This approach will help avoid complications that may arise if nondeductible losses occur.

**Line 9 – Nonrecurring Unemployment Compensation:** Nonrecurring unemployment compensation payments must be subtracted from Total Income. However, if it is typical for the borrower to be laid off seasonally (for example, a construction worker or landscaping laborer) do not subtract the reported amount from Total Income.

Unemployment compensation must appear in two consecutive years of tax returns and must be relatively consistent. In addition, the borrower's current job must be subject to the same seasonally affected layoff. If these conditions do not exist, subtract the amount reported from Total Income.

**Line 10 – Social Security Benefits:** Determine the difference between the total and the taxable social security benefits paid to the borrower and add the calculated amount to Total Income. In addition, deduct any nonrecurring taxable benefits. Supporting documentation must be obtained (statement of benefits) to confirm the continuance of this income. Scheduled benefit payments must continue for a minimum of three years to be considered as qualifying income. The tax-exempt portion of this income can be grossed up according to the guidelines that address tax-exempt income.

**Line 11 – Nonrecurring Other (Income) Loss:** Subtract other income from the borrower's Total Income unless documentation can be obtained to verify that the receipt of the income will be consistent and on going (minimum of three years). Add back other losses to Total Income if documented to be nonrecurring.

**Adjustments to Income:** Form 1040 allows for the reduction in Total Income for items such as IRA contributions, moving expenses, various expenses associated with self employment, and others. This worksheet begins with Total Income (Form 1040); therefore, an adjustment is not necessary for these items. Note however, that if the borrower is claiming an adjustment on Form 1040 for alimony paid, this obligation must be factored into the borrower's monthly debt payments to calculate the total debt-to-income ratio.

### *Schedule A (Form 1040) – Itemized Deductions*

A review of Schedule A will give the lender an indication of whether the borrower has owned real estate in the past and if there was a lien against a property (institutional or private). Interest paid on owner-occupied real estate and real estate taxes are itemized on Schedule A. Interest and real estate taxes paid on investment properties are reported on Schedule E (*Supplemental Income and Loss*).

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

standard mileage deduction, multiply the business miles driven by the depreciation factor for the appropriate year and add the calculated amount to the borrower's cash flow.

**Line 20 – Travel, Meals, and Entertainment:** These expenses relate to the cost of business-related travel, meals, and entertainment and therefore the full amount of these expenses should be taken into account when determining the borrower's actual cash flow. A portion of these expenses is excluded for meals and entertainment, subtract this exclusion from Total Income.

**Line 21 – Business Use of Home:** Add to Total Income any expenses for business use of home.

**Line 22 – Amortization/Casualty Loss:** Amortization expenses are usually one-time costs that are distributed over a period of time and can therefore be added to Total Income. Casualty losses are typically nonrecurring, add them to Total Income.

#### *Schedule D (Form 1040) – Capital Gains and Losses*

Note that we negated Schedule D gains or losses earlier. Evaluate the consistency and likelihood of continuance of any gains or losses reported on Schedule D. Compare at least two consecutive years of Schedule D to determine whether or not the income or losses are recurring. Confirm the likelihood of continuance by obtaining documentation that supports the borrower's ownership of assets that will produce future gains or losses. Also, ensure that pass through income from Schedule K-1 is not included.

**Line 23 – Recurring Capital Gains/Losses:** Add recurring gains to Total Income and deduct recurring losses from Total Income.

#### *Form 4797 – Sales of Business Property*

**Line 24 – Recurring Capital Gains/Losses:** Add recurring gains to Total Income and deduct recurring losses from Total Income.

#### *Form 6252 – Installment Sale Income*

**Line 25 – Principal Payments:** Only gains, losses, and principal repayments are reported on this form (interest income is reported on Schedule B) and are carried forward to Schedule D and Form 1040. Schedule D gains or losses were negated in the first part of the analysis. Add principal payments to the borrower's income only when they are determined to be stable and recurring. Obtain a copy of the note or contract to verify that payments will continue for at least three years.

#### *Schedule E (Form 1040) – Rent and Royalty Income*

Income or losses reported on Schedule E was initially negated in the first part of the analysis. In this section of the worksheet, determine to what extent income or losses from real estate rental activities and royalties can be included in the analysis. Income or losses from partnerships and S corporations, which are also included on Schedule E, will be addressed below.

**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 32 – Depreciation:** Add any depreciation reported on Schedule F to Total Income.

**Line 33 – Amortization/Casualty Loss/Depletion:** Add amortization, casualty loss, and depletion expenses reported on Schedule F to Total Income.

**Line 34 – Business Use of Home:** Add expenses for business use of home, as reported on Schedule F, to Total Income.

*Partnership Schedule K-1 (Form 1065)*

**Line 35 – Ordinary Income (Loss):** Subtract ordinary losses from the borrower's income. Add ordinary income from the Schedule K-1 to borrower's income only if:

- The business has positive sales and earnings trends;
- The business has adequate liquidity to support the withdrawal of earnings (Review the history of withdrawals shown in the analysis of partner's capital account on the first page of the Schedule K-1 to determine a history or pattern of prior withdrawals. Review the partnership's financial position and liquidity to determine the overall ability of the business to support the borrower's withdrawal of earnings.); and,
- The borrower can document ownership and access to the income through a partnership resolution. (A majority ownership position, as disclosed on the first page of Schedule K-1 and indicating a majority ownership of capital, will provide sufficient evidence.)

**Line 36 – 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.

**Line 37 – Guaranteed Payments to Partner:** Add guaranteed payments to partner to the borrower's income when the borrower has at least a two-year history of having received them.

*S Corporation Schedule K-1 (Form 1120S)*

**Line 38 – Ordinary Income (Loss):** Subtract any ordinary losses shown on Schedule K-1 from the borrower's income. Add ordinary income to the borrower's income only if

- The business has positive sales and earnings trends;
- The business has adequate liquidity to support the withdrawal of earnings (Review the history of distributions and the S corporation's financial position and liquidity to determine the ability of the business to support the borrower's withdrawal of earnings.); and,
- The borrower can document ownership and access to the income through a corporate resolution. (A majority ownership position, as disclosed on the first page of Schedule K-1 and indicating a majority ownership of capital, will provide sufficient evidence.)

**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 45 - 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 1065, 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 46 - Meals and Entertainment Exclusion:** Subtract the meals and entertainment exclusion reported on Schedule M-1 of Form 1065 from the business income.

**Line 47 - Subtotal:** Add/Subtract all amounts on lines 40 to 46 to determine the amount to be recorded on this line.

**Line 48 - Partnership Total:** Multiply the subtotal (line 47) by the borrower's ownership share of the partnership. The borrower's share of ownership is based on his or her percentage ownership of capital (at end of year) as reported on the Schedule K-1.

### *S Corporation – Form 1120S*

Form 1120S represents an S corporation's distributive earnings and losses. This income or loss is reported for taxation purposes to the individual shareholders on Schedule K-1 (Form 1120S). The borrower's share of ordinary (net) income or losses from the business has already been addressed in the evaluation of Schedule K-1 (Form 1120S). The analysis of Form 1120S will enable a lender to consider certain adjustments to the ordinary income or losses reported on Schedule K-1.

When analyzing Form 1120S, only the borrower's share of income or loss adjustments should be used to calculate income. The borrower's share is based on his or her percentage of stock ownership as reported on the Schedule K-1. The worksheet provides for this calculation.

**Line 49 - Nonrecurring Other (Income) Loss:** Subtract other income or add other losses that are not consistent and recurring.

**Line 50 - Depreciation:** Add depreciation to income.

**Line 51 - Depletion:** Add depletion to income.

**Line 52 - Amortization/Casualty Loss:** Add amortization or casualty loss to income.

**Line 53 - 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 1120S, 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 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 business.)

**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.

**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.

**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.