

Say "Yes" to good loans!

SAMPLE PAGES FROM

CASHFLOW ANALYSIS OF 1040 TAX RETURNS

2006 FORMS AND SCHEDULES

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Linda Gabbert Keith, CPA, CSP works with banks and credit unions to develop consistent, clear guidelines and tools for loans to businesses and their owners.

Her training helps lenders say "Yes" to good loans. She is known as 'the CPA who likes to play.' While making the right loan decision is serious business, there is no reason not to have some fun while learning about it...or training others.

Linda is also known for her ability to provide complicated information in a simplified way and a relaxed atmosphere. Who else would come up with a Lego model of a tax return! The information is practical and can be put to use immediately.

Experienced in public accounting, business consulting and corporate training, she shifted in 1986 to loan consulting and training on Financial Statement and Tax Return Analysis.

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Linda had the opportunity to share her insights on business lending with bankers in Khabarovsk, Russia by invitation of The Central Bank of Russia.

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***Please note:** This publication is designed to provide accurate and authoritative information in regard to the subject covered. It is sold with the understanding that the author is not engaged in rendering legal or accounting services. This manual should not be used as a substitute for adequate training or consultations with professional advisors, when necessary.*

Policies and procedures vary. Consult the policies and procedures of your company or a senior lender before making adjustments recommended here.

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SUGGESTED PROCEDURE FOR CASHFLOW ANALYSIS

This procedure will assist the lender in keeping track; help document the thought process, questions and judgment calls; provide a tool for *selling* the loan recommendation and enable senior lenders to evaluate.

1. ALWAYS USE A WORKSHEET!

2. PROCEED LINE-BY-LINE

through the first page of the Form 1040. When you come to a line that is carried forward from another Form or Schedule, circle the number and go find it on its supporting schedule. Circle the number when you find it and be sure it is the number you are looking for. This ensures you have all of the schedules that support the front page of the return. Proceed line-by-line down that schedule, then return to the page from which you came.

3. FOR EACH ENTRY ON THE RETURN

your choices are:

AGI METHOD

...no adjustment necessary.

...adjustment necessary and can be determined with information available, enter on appropriate line of the cashflow worksheet.

...not sure, adjustment cannot be determined from information available or need additional documentation, enter on question sheet.

SCHEDULE ANALYSIS METHOD

...include in cashflow, enter on worksheet.

...do not include in cashflow, enter a zero on worksheet and explain.

...need additional information or documentation, enter on question sheet.

...if business or rental schedule, use bottom-line income and see AGI method.

4. AFTER EACH FORM OR SCHEDULE

has been reviewed take a look at the cashflow worksheet section for that form to see that you have considered all

important items. Then put a check mark at the bottom of that page on the tax return and return to the source schedule or form.

5. IF THE TAXPAYER HAS INCOME FROM A CONTROLLED CORPORATION, PARTNERSHIP OR S CORPORATION and you are doing a personal analysis, use the 1040 as the master tax return and handle each source entity as it feeds into the 1040 (on the wage line for Corporations and Schedule E, Page 2 for Partnerships and S Corporations).

6. CONTINUE THROUGH PAGE TWO of Form 1040. (See page 2-15 for what to look for on the second page of the 1040).

When you are to the bottom of page two you should have reviewed every relevant page of the tax return. Confirm this by flipping through the pages and looking for your check mark at the bottom of each.

There are some pages that are not relevant to your cashflow analysis and will not have checkmarks on them. These include Alternative Minimum Tax forms and some additional schedules the preparer may include such as detailed equipment/depreciation lists.

7. RUN A TAPE

of what you have so far and assumptions on the questions for the borrower. If there is no way they can qualify you may have enough information to decline the loan at this step. If they qualify already then perhaps you don't need to ask **all** of the questions you had in mind.

8. RESOLVE QUESTIONS

for the borrower, another lender or underwriter. Note the date and time you spoke with that person. If you are not confident of the questions you have for the borrower, run them by another lender first.

If you now decide that some of the questions you wrote down as you went are not needed, remove the questions or indicate they are not material. Do not

leave unanswered questions in the file.

9. MAKE ADDITIONAL ENTRIES

in the worksheet if the answer you received from the borrower warrants it. SHOW ALL CALCULATIONS!

10. NOW ADD UP THE NUMBERS.

Do they qualify?

11. IF YOU HAVE TO MAKE A JUDGEMENT CALL calculate cashflow using the most conservative assumption. Make a note where you will notice it, however: IF MORE QUALIFYING INCOME IS NEEDED...

Only pursue the question if it makes a difference in whether the borrower will qualify. If you choose not to pursue a significant adjustment because it is not needed to qualify, make note of it in case you need it later or it should be considered in a future loan request.

* The items with an asterisk will not always require additional documentation, depending on guidelines/procedure of your financial institution. If the income item is not needed to qualify then you may be able to forego additional documentation.

An example: Wages are sufficient to qualify your borrower so you choose not to get additional documentation regarding alimony received and interest received.

If you are unsure as to whether they qualify without it, consider requesting the documentation up front rather than to waste time and delay the loan request by having to go back to the borrower for more. On the other hand, once something is in your files you may have to consider it. Shredding probably is not an option!

Use your judgment and know your guidelines. The documentation indicated is my recommendation.

ITEM:	COMMON DOCUMENTATION:	COMMENTS:
Wages	W-2, Line 5 Current pay stub	Most lenders use wages before optional 401K type deductions. If wages have increased dramatically at current job, is it from a promotion or nonrecurring bonuses/overtime?
Wages: Own Company	W-2 Current pay stub Two years Form 1120 Corporate or 1120S S Corporation Tax Return if borrower owns sufficient % Recent Year-to-date Income Statement	Need to verify that a closely held corporation in which borrower is a high % owner is generating sufficient income to cover wages received. If wages are not enough to qualify, lender may give credit for additional funds generated by the corporation in some situations. The percentage ownership that triggers the requirement for the corporate return is a matter of guidelines. See my manual on Corporation Tax Returns.
Interest* Dividends*	Two years 1040 Current Net Worth Statement Application Copies of Notes/ Contracts	Only verify interest/dividend income when significant in amount. The lender may use the application/Net Worth Statement to verify that assets are still held. Add tax exempt interest and nontaxed dividends if recurring. Gross up (see page 1-12) if guidelines allow. Will some of the assets be used for down payment of a mortgage loan? If receiving payments on a contract, use total received <u>instead of</u> interest.
Alimony Received*	Copy of divorce decree 2 years 1040 Copies of Bank/CU statements	Verify alimony received if necessary to qualify for the loan. If you are unsure, request documentation. Which of the documentation items and how many months statements depend on your guidelines.

ITEM:	COMMON DOCUMENTATION:	COMMENTS:
Business Income, Sole Proprietor or Farm	2 years 1040 Year-to-date Financial Statements	The <i>consumer/mortgage lender</i> will need to determine ongoing cashflow available to the borrower from the business. If not significant or hobby in nature, you might waive requirements for an updated financial statement and disregard the income/loss. The <i>commercial lender</i> recognizes the 'profit' is also compensation to the owner and not all available to service debt.
Capital Gains* Capital Losses RE Contract Stock Sales RE Sales	1040 Tax Returns Copy of Contract Current Net Worth Statement if Stock or RE sold RE Closing Statements Stock Broker Statements	If capital gains/losses are not significant, nonrecurring or are clearly not needed to qualify the borrower you can forego documentation. Many lenders prefer to use at least three years tax returns when relying on recurring capital gains. If the gain/loss is recurring and assets sold were not replaced (sell-off of stock or RE), lender should consider giving credit for net proceeds from sales, which will be different than taxable gain or loss. If a loss, it may camouflage positive cashflow in the current year depending on when the borrower paid for the item. If it is recurring income from an installment sale, (note or contract receivable) include full payments in cashflow, not just gain and interest.
IRA* Pension* Social Security*	1040 tax returns 1099 W-2P	Is this recurring or a one time lump-sum distribution? If recurring give credit for the entire amount received. (See page 1-12 regarding grossing up nontaxed portion.) If the IRA/Pension is reported on the total lines with none taxable, it is either a rollover (no adjustment/income) or a withdrawal from a Roth IRA. If no social security is taxable, it may not be reported at all. Use 1099 from SS for documentation.
Rentals	1040 tax returns Signed leases Complete REO Property Analysis form	Use actual cashflow from the past two year's returns. If the property has not been held that long or was purchased since then, a formula is used. The Property Analysis Form will save time.

ITEM:	COMMON DOCUMENTATION:	COMMENTS:
Partnership Income	1065 K-1 Form 1065, Tax Return if partner owns sufficient % Recent Year-to-date Financial Statements	The lender has to determine both the cashflow received by the borrower and, with higher % owners, the borrower's share of cashflow generated by the partnership. The number on Page Two of the 1040, Schedule E cannot be used for cashflow from the partnership. See manual on CASHFLOW OF PARTNERSHIPS AND CORPORATIONS for details on analysis.
S Corporation Income	1120S K-1 Form 1120S S Corporation Tax Return if borrower owns sufficient % Recent Year-to-date Financial Statements	The lender has to determine both the cashflow received by the borrower and, with higher % owners, the borrower's share of cashflow generated by the S corporation. The number on Page Two of the 1040, Schedule E cannot be used for cashflow from the S corporation. See manual on CASHFLOW OF PARTNERSHIPS AND CORPORATIONS for details on analysis.
Estate/Trust*	Estate or Trust Tax Return (1041) for two years Trust document	Documentation is necessary only if the income reported on the tax return was actually received or could be received, is expected to continue (ask the borrower about both) and is needed to qualify for the loan. Trust income may appear to be consistent but may not be continuing ...ask.
Unemployment Compensation*	Two years 1040	Use as income and obtain documentation only if unemployment compensation is seasonal and recurring.
Other income*	2 years 1040 Other documentation	Ask the borrower the nature of the income. Document recurring income necessary to qualify the borrower. Net Operating Losses (NOLs) are reported on the Other Income Line but do not reduce cashflow.
Child Support*	Divorce decree Evidence of receipt	Your borrower does not need to give you this information if they do not need the child support to qualify. If the children are near 18 determine how long the child support will continue.

ITEM:	COMMON DOCUMENTATION:	COMMENTS:
Keogh/SEP* Contributions	None	This may be a required or an optional contribution. If optional, it can be added back in the AGI method and ignored in the S/A method. If significant to the loan decision ask the borrower if it is optional. If the borrower is the only 'employee' of the sole proprietorship, it is functionally optional and can be added back (AGI method) or ignored (S/A method).
Alimony paid Child Support paid	Copy of divorce decree or legal separation	Alimony and child support paid may be counted against your borrower as part of the debt calculation or as an income reduction depending on the guidelines of your financial institution. Ask the borrower how long it will continue! If less than 6, 10 or 12 months (according to your guidelines) it may not have to be counted as debt <u>or</u> against income. You would need documentation to support this. I recommend it be treated as an income shift between households, and therefore subtracted from income rather than put on the debt list. This can make <u>the difference</u> in qualifying the borrower.

HOW THE FRONTLINE PERSONNEL CAN ASSIST THE CREDIT OFFICER IN OBTAINING ADEQUATE DOCUMENTATION:

Go down through Page One and Two of the 1040 and trace the numbers to the appropriate schedules. Incomplete tax returns are often submitted which do not give the lender the information needed and slows down the loan process.

Compare rentals reported on the tax return to your application or the Real Estate Owned Property Analysis Form. The borrower may call a property the Tumwater Hill property on the application and 311 S. D Street on the tax return. The lender has to know which property is which to calculate qualifying income.

If a property is listed on the tax return but not on the application, verify with the

borrower that they no longer own the property. The sale may have resulted in additional cashflow if they held the contract or deposited it in your financial institution.

If the rental is on the application but not on the return, verify it was purchased since the tax return date and get required documentation, scheduled rents and payment (PITI) figures.

In some cases, you are knowledgeable about tax return analysis but are over your approval limit. By analyzing the return yourself and with your more complete knowledge of the borrower, you can get questions answered and additional information needed before you submit the package to the decision maker.

With **Part I Short-term gains and losses**, the column (f) gain/loss is the cashflow. With **Part II Long-term**, we cannot determine cashflow without a broker's statement for stock or closing statements for Real Estate.

NONCASH ITEMS

Always check first to see if the entries are on a noncash line. If so, then you can ignore it (S/A Method) or subtract gain/add back loss (AGI Method).

Anything on Lines 5, 6, 12 & 14 is noncash and should not be considered.

In the Crocket/r return, that eliminates from consideration the loss of \$22,400 on Line 14.

Before I would add that back using the AGI method I'd look at the rest of what we have and make one adjustment instead of several.

LINES 4 AND 11

These are catch-all lines that can come from several sources.

Form 2439 Undistributed capital gains

Mutual funds may keep some of their long-term capital gains and pay taxes on those undistributed amounts. The taxpayer must report his/her share of these amounts as long-term capital gains, even though s/he did not actually receive a distribution.

The fund will send a Form 2439, instead of Form 1099-DIV, showing taxpayer share of the undistributed long-term capital gains. Since it was not distributed, we can leave it out (S/A method) or take it out (AGI method) of cashflow.

Form 4684 Business Casualty Loss

If you can trace the figure on Line 4 or 11 to the 4684, you can leave it out (S/A method) or take it out (AGI method) since we assume casualty losses are nonrecurring.

Form 4797 Gain/Loss on Business Assets

This includes involuntary conversions other than from theft on property held more than one year. We generally leave it out (S/A method) or take it out (AGI method) as it is unlikely to be recurring.

This may also include installment sale income from the same type of transactions. If

so, you will have already found the interest associated with it on Schedule B and asked the borrower about full payments received.

Form 6252 Installment Sales

You should have spotted the interest income already on Schedule B. If continuing long enough you will give them credit for full note payments received. We leave it out (S/A method) or take it out (AGI method) since we are giving them credit for it elsewhere.

Form 6781 Gains/Losses from Section 1256 Contracts and Straddles (Mark to Market, etc.)

This is another type of stock transaction. In most cases we will not use it as recurring income since we cannot count on it continuing. Leave it out (S/A method) or take it out (AGI method).

Form 8824 Like-Kind Exchanges

When the borrower has simply exchanged one type of business or investment property for another, and no cash has changed hands, there will be no gain or loss.

Like-Kind Exchanges are reported on Form 8824 which is required to be attached to the return.

If there is recognizable gain because the borrower's property was worth more than the property exchanged for and so received cash in addition to the other property, that amount will come in on Line 4 or 11 of the Schedule D or Line 5 or 16 on Form 4797.

TIP:

The gain will eventually have to be paid when they finally sell the 'last' property.

LINE 13 CAPITAL GAIN DISTRIBUTIONS

These distributions are paid by mutual funds from their net realized long-term capital gains. These are really **dividends**. The amount you find here can be added to your dividends line on your worksheet.

Continued on page 2-32