

Underwriting the FHA Appraisal

9:00 AM Mountain Time

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- ❖ A copy of this Power Point presentation
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Important Things to Know

Archive Version (POP-UP)

<http://www.hud.gov/offices/hsg/sfh/talk/parc/phiarch.cfm>

Where to Get More Information

www.hud.gov/fha

The main web site for the latest news on FHA programs

<http://www.hud.gov/offices/adm/hudclips/index.cfm>

HUDCLIPS - the source for FHA policy documents (handbooks, mortgagee letters and notices)

EEM

(Energy Efficient Mortgage)

- ❖ What is an EEM?
 - ❖ Allows homeowners to improve the energy efficiency of their home by financing the cost of the improvements into their loan.
 - ❖ If the savings in utility costs will more than pay for the costs of the improvement, borrower does not have to qualify for the extra costs of the energy improvements.
- ❖ Who is eligible?
 - ❖ New and existing 1-4 units including condominiums and manufactured homes
 - ❖ Purchases, streamline refinances, no cash-out refinances, 203(h) disaster loans, and 203(k)
- ❖ rehabilitation mortgages
 - ❖ Homeowners
- ❖ How do you apply?
 - ❖ Find a EEM lender
 - ❖ Purchase a HERS report from an acceptable source (utility company, local state or federal agency or nonprofit)
 - ❖ Qualify for the base mortgage before the energy efficient improvements are added
 - ❖ No second appraisal is needed to support added costs

EEM

(Energy Efficient Mortgage)

❖ Want More Information?

❖ **EEM Webinar is archived**

❖ See Mortgagee Letters;

❖ ML 2009-18 ML 1995-46

❖ ML 2005-21 ML 1993-13

❖ See HUD Handbook 4155.1 6.D.1

❖ Department of Energy's website:

[http://www.energystar.gov/index.cfm?
c=home_improvement.hm_improvement_contractors#s1](http://www.energystar.gov/index.cfm?c=home_improvement.hm_improvement_contractors#s1)

DISCLAIMER

- **The purpose of this presentation is an overview of the subject matter with summation and explanation of recent changes in FHA policy. It introduces and explains, rather than supplants, official policy issued in Handbooks and Mortgagee Letters. If you find a discrepancy between the presentation and Handbooks, Mortgagee Letters, etc., the official policies prevail. Please note the information provided in this training is subject to change.**
- **Please consult HUD online Handbooks at <http://www.fhaoutreach.gov/FHAHandbook/prod/contents.asp?address=4155-1> and Mortgagee Letters through <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/index.cfm> for the most recent updates and current policy.**

UNDERWRITING THE SELF-EMPLOYED BORROWER

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REFERENCES

HUD HANDBOOK 4155.1, Section 4

ML 2012-03

TOTAL USER GUIDE ML 2004-47, Revised 4/6/12
(*Link found in Jerrold Mayer e-mail released on 2/11/12)

IRS WEBSITE: WWW.IRS.GOV

INCOME TAX ANALYSIS FOR S/E BORROWER

IRS FORMS AND SUPPORTING SCHEDULES

FORM 1040 – U.S. Individual Income Tax Return

SCHEDULE A – Itemized Deductions, any 2106 Expenses

SCHEDULE B – Interest and Ordinary Dividends

SCHEDULE C – Profit and Loss from Business

SCHEDULE D – Capital Gains and Losses

SCHEDULE E – Supplemental Income and Loss

SCHEDULE F– Farm Income and Loss

FORM 1065 – U.S. Return of Partnership Income

SCHEDULE K-1 - 1065) – Partner's Income, Deductions, Credits

FORM 1120S – U.S. Income Tax Return for an S-Corporation

SCHEDULE K-1 - 1120S) – Shareholder's Income, Deductions, Credits

FORM 1120 – U.S. Corporation Income Tax Return

SELF-EMPLOYED BORROWERS

- ❖ 25 PERCENT OR GREATER OWNERSHIP INTEREST
IN A BUSINESS
- ❖ LENDER TO DETERMINE PERCENTAGE OF
OWNERSHIP

DOCUMENTATION REQUIREMENTS

- ❖ SIGNED AND DATED INDIVIDUAL TAX RETURNS WITH ALL APPLICABLE SCHEDULES FOR THE MOST RECENT TWO YEARS
- ❖ SIGNED COPIES OF FEDERAL BUSINESS INCOME TAX RETURNS FOR THE LAST TWO YEARS, WITH ALL APPLICABLE SCHEDULES, FOR CORPORATION OR PARTNERSHIP
- ❖ YEAR-TO-DATE PROFIT-AND-LOSS (P&L) STATEMENT AND BALANCE SHEET – See ML 2012-03
- ❖ BUSINESS CREDIT REPORT ON CORPORATIONS AND “S” CORPORATIONS

UNDERWRITING ANALYSIS

- ❖ ANALYZE 2 OR MORE TAX YEARS AND YEAR-TO-DATE P&L / INCOME STATEMENT AND BALANCE SHEET
- ❖ THE BUSINESS HAS POSITIVE SALES AND EARNINGS TREND
- ❖ THE OWNER OF THE BUSINESS HAS ADEQUATE LIQUIDITY TO SUPPORT THE WITHDRAWALS; AND
- ❖ IRS FORM K-1 SHOULD BE INCLUDED WITH S-CORPORATIONS & PARTNERSHIPS

MINIMUM LENGTH OF SELF-EMPLOYMENT

- ❖ TWO OR MORE YEARS TO BE CONSIDERED STABLE AND EFFECTIVE
- ❖ BETWEEN ONE AND TWO YEARS
 - ❖ Additional documentation evidencing at least 2 years of previous employment in the same line of work or related occupation
- ❖ LESS THAN ONE YEAR
 - ❖ **NOT considered effective income!**

SOLE PROPRIETORSHIP

DEFINITION:

- ❖ A SOLE OWNER OR PROPRIETORSHIP IS A BUSINESS OR FINANCIAL VENTURE CARRIED ON BY A SINGLE PERSON
- ❖ THE INCOME, BUSINESS EXPENSES AND TAXABLE PROFITS ARE REPORTED ON **SCHEDULE C**
- ❖ WHEN REVIEWING IRS FORM 1040 AND ACCOMPANYING SCHEDULES, STANDARD ADDITIONS TO INCOME ARE: DEPRECIATION AND DEPLETION TO BORROWER'S QUALIFYING INCOME

CORPORATE TAX RETURN

IRS FORM 1120

- ❖ IDENTIFIES CORPORATION'S INCOME, DEDUCTIONS AND TAXES
- ❖ BORROWER'S PERCENTAGE OF OWNERSHIP IS DETERMINED ON PG 2 OF 1120 IN SCHEDULE E
- ❖ ANALYZE AT LEAST TWO YEARS OF **IRS FORM 1120** AND ALL SUPPORTING SCHEDULES
- ❖ ADD OR SUBTRACT ONLY BORROWER'S SHARE OF INCOME OR LOSSES

“S” CORPORATION TAX RETURN

IRS FORM 1120-S

- ❖ IDENTIFIES STOCKHOLDER'S SHARE OF S-CORP. INCOME, LOSS AND DEDUCTIONS
- ❖ COMPENSATION TO ITS OFFICERS PROPORTIONATELY TO THE PERCENTAGE OF OWNERSHIP IS SHOWN ON THE CORPORATE TAX RETURN AS WELL AS ON INDIVIDUAL TAX RETURN
- ❖ BORROWER'S OWNERSHIP PERCENTAGE IS DETERMINED ON SCHEDULE K-1 (FORM 1120S)
- ❖ ANALYZE AT LEAST TWO YEARS OF **IRS FORM 1120-S** WITH ALL SUPPORTING SCHEDULES INCLUDING **SCHEDULE K-1 (1120-S)** FORMS

PARTNERSHIP TAX RETURN

IRS FORM 1065

- ❖ ANALYZE AT LEAST TWO YEARS OF **IRS FORM 1065**
- ❖ THE PARTNERSHIP'S ORDINARY INCOME OR LOSS IS DIVIDED AMONG PARTNERS.
- ❖ DETERMINE BORROWER'S OWNERSHIP PERCENTAGE FROM **SCHEDULE K-1 (FORM 1065)**

SCHEDULE E – SUPPLEMENTAL INCOME AND LOSS

- ❖ FROM RENTAL REAL ESTATE, ROYALTIES, PARTNERSHIPS, S-CORPORATIONS, ESTATES, TRUSTS, ETC.
- ❖ CHECK EACH PROPERTY LISTED ON SCHEDULE E PAGE 1 AGAINST THE BORROWER'S SCHEDULE OF REAL ESTATE OWNED ON THE URLA
- ❖ EXCLUDE INCOME OR LOSS FROM ANY PROPERTY THAT THE BORROWER NO LONGER OWNS

SCHEDULE E CONT

- ❖ ONGOING RENTS AND ROYALTIES RECEIVED ARE ADDED TO BORROWER'S CASH FLOW – Line 3 on Schedule E
- ❖ ONGOING EXPENSES ARE SUBTRACTED FROM BORROWER'S CASH FLOW – Line 19 on Schedule E

YEAR-TO-DATE P&L STATEMENT

- THE INCOME IDENTIFIED ON P&L STATEMENT MAY ONLY BE CONSIDERED IF THE INCOME IS:
 - ❖ In line with the previous year's earnings; or
 - ❖ Is reported through audited financial statements
 - ❖ If income from the P&L is used to qualify the borrower and it exceeds the 2 year average of tax returns, an "Audited" P&L or signed quarterly filed tax returns obtained from IRS are required, per the ML 12-03
 - ❖ If using the P&L income to qualify, multiply the amount by the percentage of individual ownership first, then add to borrower's qualifying income

INCOME TAX ANALYSIS METHOD FOR THE SELF-EMPLOYED BORROWER

I. Individual Tax Return (IRS Form 1040)

1. Line 7 of 1040, page 1 with W-2's
(from owned business interest – such as from an 1120)
2. Schedule A
 - a. Check for any 2106 unreimbursed expenses

SCHEDULE B & D

3. Schedule B-Interest and Dividend Income
(received for 2 years)

4. Schedule D- Capital Gains and Losses
 - a. Recurring Capital Gains (Add if earnings have been received for 3 years)
 - b. Non-Recurring Capital Loss

SCHEDULE C

5. Schedule C – Sole Proprietor

- a. Net Profit or Loss, Line 31
- b. Depreciation, Line 13
- c. Depletion, Line 12

SCHEDULE C SCENARIO

Mr. Smith has filed Schedule C income as Consultant and also teaches tax laws on the side with a separate Schedule C with a Net Profit of \$1,500 on line 31. On his Consultant Schedule C, his Gross Income on line 7 = \$475,933. He listed zero income for Depletion on line 12 and \$15,350 income for Depreciation on line 13. He also listed \$230 on line 24b for Meals & Entertainment. He has zero listed on line 30 for Business use of Home and his Net Profit on line 31 is \$52,761. Which of the following monthly income amounts below is the correct one to be used for qualifying on the Schedule C for Consultant Job:

- a.) \$5,656.75
- b.) \$5,675.91
- c.) \$4,396.75
- d.) \$39,661.08

Can the lender use the additional Schedule C of \$1,500 as well on his part time job of teaching tax laws?

What if Mr. Smith has 1,200 business miles reflecting on page 2 of his 2011 IRS Schedule C? Can this be added back in?

SCHEDULE E

5. Schedule E – Rent Part I

- a. Profit or Loss, Line 26
- b. Depreciation, Line 20

Note: Rental (Loss) is counted as a monthly liability and
not averaged in income.

6. Schedule E – Part II Misc. Business Income

- a. Profit or Loss, Line 32

*Part III on Schedule E, page 2 is Income/Loss from Estates
or Trusts. See 4155.1, Section 4.E.2.b thru d

SCHEDULE E SCENARIO

Mr. Jones has a rental property on 123 Main St. Denver, CO listed on his Schedule E page 1. His Total Rents Received on line 3 is \$24,600. On line 19, he states the total of lines 5 thru 18 = \$21,270. On line 20 he lists \$11,088 for Depreciation and on line 26 he lists his total rent income/loss = (-) \$7,758. Which of the following income amounts would be correct to use for qualifying:

- a.) \$1,537.50 a month
- b.) \$ (-) 646.50 a month (*this must be listed as a liability & not as income since it is a negative amt.)
- c.) \$277.50 a month

SCHEDULE F

7. Schedule F – Farm Income (If not subject property)

a. Profit or Loss

b. Depreciation

TOTAL ALL EARNINGS LISTED IN I. #'s 1 thru 7

FORM 1120

II. Corporate Tax Returns (Form 1120)

1. Net After Tax Income

- a. Depreciation (+) Line 20
- b. Depletion (+) Line 21
- c. Lump Sum debt (Mtg./Note) that is due within 1 year, (-)
See Schedule L, Line 17, column d
- d. Subtotal of a + b and subtract c
- e. Percentage of ownership x d

TOTAL ALL EARNINGS FOR PART II

FORM 1120-S

III. S-Corporation Tax Returns (Form 1120-S)

- a. Depreciation (+) Line 14
- b. Depletion (+) Line 15
- c. Lump sum debt (Mtg./Note) due within 1 year (-)
See Schedule L, line 17, column d
- d. Subtotal a + b and subtract c
- e. Percentage of ownership x d

TOTAL ALL EARNINGS FOR PART III

1120S CORP SCENARIO

Mr. Davis is single and he's 50% business owner of Carpets Plus, Inc. His 1040 tax returns reflects W-2 income from Carpets Plus, Inc. on line 7 of page 1 as \$18,000. It also reflects Schedule E income on line 17 of page 1 of \$18,193. He does not own any rental properties. His Schedule E page 2 reflects \$18,193 as well. He has provided a copy of his 1120s business tax returns and page 1 reflects \$36,000 on line 7 for Compensation to Officers and \$2,000 on line 14 as Depreciation. Line 21 income/loss reflects a total of \$36,386. Schedule L line 17 reflects zero on Notes due in < than 1 year. His K-1 confirms him having 50% ownership and on line 1 his total income/loss states \$18,193.

Which of the following would be the correct self-employed income calculation amount that should be used to qualify:

- a.) \$1,516.08
- b.) \$3,016.08
- c.) \$3,099.41
- d.) \$3,182.75

FORM 1065

IV. Partnership Tax Returns (Form 1065)

- a. Depreciation (+) Line 16a
- b. Depletion (+) Line 17
- c. Lump Sum debt (Mtg./Note) due within 1 year (-)
See Schedule L, Line 16, column d
- d. Subtotal a + b, subtract c
- e. Percentage of ownership x d

TOTAL ALL EARNINGS FOR PART IV

Y-T-D P&L STATEMENT

V. YTD Profit & Loss Statement and Balance Sheet

- a. Net Income/Loss
- b. Depreciation (+)
- c. Depletion on P&L (+)

Note: The total assets on the Balance Sheet should match the total liabilities & shareholder's equity.

TOTAL ALL EARNINGS FOR PART V

VI. Total Income: Add I, II, III, IV and V

AVERAGING INCOME & ADDITIONAL INCOME

VII. Averaging Income

(A) Add columns (minimum 24 months) for combined income

(B) Total Number of months for all columns

Average the total income: Divide (A) by (B)

VIII. Additional Income

- All other income meeting the 4155.1 HUD Handbook (current earnings) See Section 4-E

Total all of Additional Income

TOTAL EFFECTIVE INCOME

The Total of Averaged Income and Additional Income:

Averaged Income (VII) + Additional Income (VIII) =

TOTAL EFFECTIVE INCOME

FORM 4506-T

REQUEST FOR TRANSCRIPT OF TAX RETURN

- ❖ Includes most of the line items of a tax return as filed with the IRS
- ❖ Available for the current year and returns processed during the prior 3 years
- ❖ Must be signed and dated by borrower(s)
- ❖ Limited time

SCENARIO

**CAN YOU USE A SELF-EMPLOYED INCOME
TO QUALIFY A BORROWER WHO
RELOCATED TO A DIFFERENT STATE LESS
THAN A YEAR AGO?**



THANK YOU!