TAX RETURN ANALYSIS:
ESSENTIALS & 1040 REVIEW

2014 Forms & Schedules

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Basic Approaches

The two most common approaches have variations.

**ADJUSTMENT (AGI) METHOD:**
In the adjustment method, start with the bottom line of the tax return. I call this ‘tax return income’ but the official label is **Adjusted Gross Income (AGI)** on a 1040, **Ordinary Income** on a Partnership or S Corporation return and **Taxable Income** (before NOL and Special Deductions) on a Corporate Return. Some lenders start with ‘Total income’ on the 1040.

Then review the return to make adjustments to this bookkeeping/tax number to get to **recurring cashflow available to pay debt and/or the owners.**

**SCHEDULE ANALYSIS (S/A) METHOD:**
In this method, you build cashflow item-by-item. You look at each source of income and decide if you will include it and/or if it needs adjustment before including it. You also look for items that may not be on the return or legitimately not fully reported.

**ADVANTAGES OF ADJUSTMENT (AGI) METHOD:**
With the AGI method, I think it is easier to review the work of a junior lender. You can easily see what adjustments have been made and summarize the difference between the number the borrower gave you, taxable income (AGI), and the number you are using in your qualifying income calculations.

It also is easier to self-review. I look at my starting number and try to put into a couple of sentences the main reasons why it is different than the recurring cashflow I am crediting to the borrower.

**ADVANTAGES OF SCHEDULE ANALYSIS METHOD:**
This method is more intuitive to me. You end up with a list of cashflow sources you expect. The completed worksheet gives you a snapshot of borrower cashflow.

**EITHER WAY:**
You need to review relevant, material items in a return and know what items may not be there that have impact on cashflow. You need to decide what to include and not to include in recurring cashflow.

**AGLending MIXED APPROACH**
In AgLending, the worksheet often starts with a very detailed list of all farming revenue sources and expense categories to facilitate comparing the operation from one year to the next.

Depreciation (sometimes called use cost) is entered on a line the system will add back to come up with debt repayment capacity.

Also, some credit officers need to carefully distinguish between term debt interest and operating line interest if their system handles them differently.

The non-farm section has less detail.

**HISTORICAL AND/OR RECURRING CASHFLOW**
We all need to get to recurring cashflow to make a good loan decision. Consumer and mortgage lenders often do this in one pass of the 1040, leaving out nonrecurring income like the occasional capital gain from a stock sale. They usually average the ‘recurring’ cashflow from the most recent two or three years.

Business and commercial real estate lenders often prefer a two-step method. They may do a historical/actual cashflow analysis of two or three years first. What did happen in the checkbook?

Once they have a good understanding of what has been happening with cashflow, they are in a better position to project the future cashflow.

On page 10, the types of adjustments are separated into historical and recurring to accommodate either approach.

**PROJECTED CASHFLOW**
I distinguish between recurring cashflow and projected cashflow, although you may use the terms differently.

For me, recurring cashflow is based on known information. Perhaps the borrower just received the last payment on a note receivable. Or they may have sold a rental. We can document this.

In my mind, projected cashflow comes into play when a business is starting, expanding or changing in
Variations on the methods

a significant way. It is based on guessing, hopefully educated guessing. Assessing projected cashflow is beyond the scope of this manual. We will focus on historical and recurring cashflow.

DEBT-TO-INCOME RATIO
This ratio is used to evaluate personal loans or the strength of a business guarantor. The personal annual debt payments are divided by the net cashflows from all sources including wages, investments, rentals and self-employment.

Debt payments related to business or rentals are generally subtracted from business or rental income rather than included in personal debt.

Debt-to-income ratios typically range from 35% to 50% if using before-tax cashflow or 45% to 60% if using after-tax cashflow.

Some financial institutions use a sliding scale. The higher the income, the greater debt-to-income ratio they allow.

NET SPENDABLE
Instead of using a debt-to-income ratio, some lenders subtract a family living expense based on number in the family and perhaps the income level. Then they either subtract debt (the answer needs to be positive) or they divide the result by debt from all activities (see debt-coverage ratio below.)

DEBT-SERVICE OR DEBT-COVERAGE RATIO
The income before interest deductions is divided by the annual debt payments. We add back the interest wherever we find it and enter the corresponding debt on the debt list.

A debt-service ratio of 1.2 to 1.3 is often required. Sometimes the ratio can be lower if the residual (after-debt) income is higher. Your guidelines may provide for a sliding scale.

With a closely held business, the debt figure used often includes personal, rental and business debt. (See ‘Global Cashflow’ on this page.)

Commercial lenders subtract owner withdrawals, dividends or distributions to owners to determine how much cashflow was left in the business to cover the business debt payments.

BEFORE-TAX VERSUS AFTER-TAX
When analyzing business owner’s returns, before-tax figures give you an equivalent to gross wages in a debt-to-income ratio approach. In my experience, before-tax is used by most consumer/mortgage lenders and perhaps half of business lenders.

When using a before-tax approach, and assuming a 40% debt-to-income ratio, the taxes are covered by the other 60% of income along with food, clothing and other expenses.

The debt-to-income ratio allowed is greater when using an after-tax income figure — perhaps 45% - 60% instead of 35% - 50%.

If you will be using after-tax figures, consider whether the income or self-employment tax should be adjusted for nonrecurring income/expenses or optional expenses you are adding back. If the income changes the taxes will change.

An NOL that has just been used up will no longer shelter income from taxes, also requiring an adjustment to taxes. (See more on NOLs on page 11.)

GLOBAL CASHFLOW
Lenders commonly look at the business and the owners as if they were one entity. The owners control what they pay themselves. By combining the analysis, the lender considers the strength of both the business and the owner/guarantors.

A common technique is to analyze the business and each guarantor separately adding back interest when you find it. Often on the personal analysis for each family an amount for family living is subtracted. Then the combined cashflow available to pay debt from the business and all guarantors is compared to the combined debt from them all.

Usually we are looking for a minimum debt coverage ratio and perhaps a minimum level of overall liquidity.
**The Six “Ns”**

### HISTORICAL OR RECURRING ...

<table>
<thead>
<tr>
<th>NONTAXED income/gain</th>
<th>NONDEDUCTED expense/loss</th>
<th>NONCASH income or expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Missing pieces</td>
<td>Missing pieces</td>
<td>Tax-impact items that do not represent cash in or out</td>
</tr>
<tr>
<td>Income not taxed</td>
<td>Expenses not deducted</td>
<td></td>
</tr>
</tbody>
</table>

**Income examples:**
- Child support rec’d
- Tax-exempt interest
- Non-taxed portion of SS, IRA, pension

**Expense examples:**
- Principal loan payments
- 50% meals/entertainment

**Expense examples:**
- Depreciation, amortization, depletion
- Carryovers
- Net Operating Loss (NOL)
- Pass-thru K-1 income/gains

### GROSS UP NONTAXED INCOME

If you subtract federal income taxes do not use this idea.

This is a common technique to get all income included at its taxable equivalent. This is ONLY needed when you use a before-tax approach and your guidelines assume all income is taxed.

If you are not sure if your company allows this adjustment, ask first.

Consistently applied to child support, tax-exempt interest, untaxed disability/social security/pension and IRAs, you multiply nontaxed income by 1.25 which brings it up to taxable income if the borrower is in a 20% bracket. Other factors:
- 1.2 factor is 15% bracket
- 1.6 factor is 39% bracket
- Or calculate: 1/(1-tax rate)
The Six “Ns”

NET OPERATING LOSS
These are carry forwards of losses related to business, work, casualty or theft. NOLs may be pass-throughs from a partnership or S corporation. They can be carried forward 15-20 years.

They are always noncash and in a 1040 are found on Page One, Line 21.

A statement showing the year it came from, how much was used each year and what is left is required.

If there is remaining NOL to carry forward, this may be a compensating factor. To the extent the borrower has an NOL, they are not paying taxes on some of their otherwise taxable income.

RECURRING (CONTINUED) ...

<table>
<thead>
<tr>
<th>NEW income/expense</th>
<th>NONRECURRING income/expense</th>
<th>NONDOCUMENTED income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Missing pieces</td>
<td>They received it or spent it but we don’t think it will continue</td>
<td>Income you do not need to qualify which would require additional documentation</td>
</tr>
<tr>
<td>New since tax return year</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Income examples:
- New rental
- New job
- New business contract

Income examples:
- Alimony (maybe)
- Contract receivable (maybe)

Income examples:
- Alimony received (maybe)
- Contract receivable (maybe)

Expense examples:
- New lease
- New alimony payments

Expense examples:
- Moving expense
- Disaster repairs
- Merger costs

Expense examples:
- New lease
- New alimony payments

AGI Method:
- Document first, then add income and subtract expenses

AGI Method:
- Add back expenses and subtract income

AGI Method:
- Subtract non-documented income
- Make note of this potential additional source of income

S/A Method:
- Document first, then add income and subtract expenses

S/A Method:
- Add back expenses and subtract income if included in a figure you are using for cashflow such as Schedule C Net Profit
- Otherwise, do not include

S/A Method:
- Subtract if it is included in a number you are using in cashflow such as Schedule C Net Profit
- Otherwise, do not include
- Make note in comments

Income examples:
- Alimony received (maybe)
- Contract receivable (maybe)

Income examples:
- Alimony (maybe)
- Contract receivable (maybe)
EXCERPT FROM THE MANUAL:

TAX RETURN ANALYSIS:

ESSENTIALS & 1040 REVIEW

2014 Forms & Explanations
Fashion Tax Return
### Form W-2: Wage and Tax Statement

**Wage and Tax Statement**

<table>
<thead>
<tr>
<th>Name</th>
<th>Social Security Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outa Fashion</td>
<td>123-65-4321</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Spouse’s W-2</th>
<th>Military: Complete Part VI on Page 2 below</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

**Employee’s social security No.:** 123-65-4321

**Employer’s ID number:** 91-1111111

**Employee’s name, address, and ZIP code:**

<table>
<thead>
<tr>
<th>Street</th>
<th>City</th>
<th>State</th>
<th>ZIP Code</th>
<th>Foreign Country</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**State of Washington**

**Control number:**

<table>
<thead>
<tr>
<th>Box 12 Code</th>
<th>Box 12 Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>D</td>
<td>3,457.00</td>
</tr>
</tbody>
</table>

**NOTE:** Enter box 13 before entering box 14.

### Box 14 below after entering boxes 18, 19, and 20.

- **Statutory employee**
- **Retirement plan**
- **Third-party sick pay**

- Enter box 12 below

- Enter amount attributable to RRTA Tier 2 tax
- Double click to link to Form 3903, line 4.
- Enter MSA contribution for Taxpayer
- Enter HSA contribution for Taxpayer
- Enter MSO contribution for Spouse
- Enter HSA contribution for Spouse
WAGES: LINE 7

You won’t always have the W-2 unless you specifically ask the borrower for it. If you have it, full wages are listed on Line 5, “Medicare wages and tips” (circled on previous page).

This is the amount of wages received before wages were reduced for nontaxed items such as dependent care benefits and 401K contributions.

S/A method can use these wages directly. AGI method adds the difference between full wages, in this case $90,940, and the wages already in AGI of $87,483. The increase is $3,457.

Watch For

Keep in mind that it also includes any overtime pay and bonuses received that year. If the wages have taken a huge jump over last year and there was no change in jobs, you may want to determine that this is a normal amount of overtime or bonuses for this borrower. In that case, you may wish to use only the base wages.

The reverse could be true. If a wage-earner took a temporary reduction in pay or hours and their current pay is back to a higher level, you may want to adjust to current wages.

Tip

MORTGAGE LENDERS!

If your cashflow worksheet requires non-self-employed wages to be listed separately from other income, do not include those wages in the cashflow from the tax return. This is common with secondary market mortgage lenders.

AGI Method would subtract non-self-employed wages listed on Line 7 of the first page of the return. S/A Method would not include them.

To Do

Outa still has her job.

AGI Method: Add $3,457 to wages.

S/A Method: Enter $90,940 for wages.

Both: Add a comment at the bottom of the worksheet to show where you got this number. (W-2, Line 5)
### Schedule B: Interest and Dividends

**Interest and Ordinary Dividends**

- **Attach to Form 1040A or 1040.**
- **Information about Schedule B and its instructions is at [www.irs.gov/scheduleb](http://www.irs.gov/scheduleb).**

<table>
<thead>
<tr>
<th>Name(s) shown on return</th>
<th>Your social security number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imin &amp; Outa Fashion</td>
<td>123-45-6789</td>
</tr>
</tbody>
</table>

#### Part I

**Interest**

1. List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions on back and list this interest first. Also, show that buyer’s social security number and address.

   - National Bank
   - LUV MY CU
   - Local S&L

   (See instructions on back and the instructions for Form 1040A, or Form 1040, line 8a.)

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>430.</td>
</tr>
<tr>
<td>830.</td>
</tr>
<tr>
<td>450.</td>
</tr>
</tbody>
</table>

2. Add the amounts on line 1.

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,710.</td>
</tr>
</tbody>
</table>

3. Excludable interest on series EE and I U.S. savings bonds issued after 1988, Attach Form 8815.

4. Subtract line 3 from line 2. Enter the result here and on Form 1040A, or Form 1040, line 8a.

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,710.</td>
</tr>
</tbody>
</table>

**Note:** If line 4 is over $1,500, you must complete Part III.

#### Part II

**Ordinary Dividends**

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 9a.)

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

**Note:** If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm’s name as the payer and enter the total interest shown on that form.

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

#### Part III

**Foreign Accounts and Trusts**

(See instructions on back.)

1. **At any time during 2014, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country?** See instructions.

   - Yes
   - No

   If “Yes,” are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements.

2. **If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located.**

3. **During 2014, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust?** If “Yes,” you may have to file Form 3520. See instructions on back.

   - Yes
   - No
**Tip**  
Schedule B is generally **not required** if taxable interest is less than $1500. The usual assumption is that interest and dividends are continuing. Don’t waste too much time on this if not material.

**INTEREST INCOME, LINES 8A AND 8B OF PAGE ONE:** You get to Schedule B from Page One of the 1040, Line 8a. While you are still on Page One, though...

**CONSIDER LINE 8B BEFORE 8A:** Why? I have noticed that when I am done with Schedule B I think I am done with interest income. So I am in the habit of checking Line 8b on page one before I head over to the Schedule B.

This is tax-exempt interest and is not required to be included on Schedule B. Add if it is recurring. The general assumption is that it is recurring.

**Digging for Dollars**
The borrower gets more bang for their buck with nontaxed income. Consider multiplying this by a factor of between 1.2 and 1.25 before adding it to cashflow if you use a debt-to-income guideline that presumes before-tax income.

This brings it on at its taxable equivalent and gives it the weight it really adds to qualifying cashflow.

**SCHEDULE B: THREE TYPES OF ENTRIES**

1) **Bank/Credit Union interest**
   
   Adjust these numbers only if significant and the underlying assets are gone.

2) **Note/Contract receivable**
   
   Guidelines vary on how to handle interest from a note/contract receivable. When using my worksheet, do not include the interest from a note/contract receivable on the interest line.

   If needed for qualifying income, ask the borrower for the full payments received and how much longer. If long enough (life of the loan or 3 years for residential loan) give credit for a full year’s payments on the ‘full note payments rec’d’ line on my worksheet.

---

**3) K-1 pass-through interest:** Leave this off the personal cashflow (subtract if using AGI method) and be sure to get the K-1 or full partnership/s corporation return to determine actual or available cashflow from the entity.

See page 20 and 21 for more information if you have any of the three exceptions described above.

**QUALIFIED DIVIDENDS**

These are the portion of dividends listed on Line 9a that are eligible for a lower tax rate than other ordinary income. Since it is included in Line 9a you do not need to add it again.

The taxes owed will be calculated a bit differently as a result of qualified dividends.

**Alternate treatment:** Use interest listed here, obtain a copy of the contract, calculate and then add the principal received if the payments will continue long enough. If you choose not to include the contract principal, you probably also will not give them credit for the interest from the contract.

---

**SCHEDULE B: Interest and Dividends**

**SECTION 2:**

**Forms & Explanations**

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**EXCERPT FROM ESSENTIALS & 1040 REVIEW**

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### Schedule C: Profit or Loss from Businesses

**Name of Proprietor:** Imin Fashion  
**Social Security Number (SSN):** 123-45-6789

**Department of the Treasury**  
**Internal Revenue Service (IRS)**

---

#### Part I: Income

1. **Gross receipts or sales.** See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked.  
2. **Returns and allowances.**  
3. **Subtract line 2 from line 1.**  
4. **Cost of goods sold (from line 42).**  
5. **Gross profit.** Subtract line 4 from line 3.  
6. **Other income, including federal and state gasoline or fuel tax credit or refund (see instructions).**  
7. **Gross income. Add lines 5 and 6.**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Gross receipts or sales</td>
<td>$427,742</td>
</tr>
<tr>
<td>2</td>
<td>Returns and allowances</td>
<td>$1,442</td>
</tr>
<tr>
<td>3</td>
<td>Subtract line 2 from line 1</td>
<td>$426,300</td>
</tr>
<tr>
<td>4</td>
<td>Cost of goods sold (from line 42)</td>
<td>$239,349</td>
</tr>
<tr>
<td>5</td>
<td>Gross profit. Subtract line 4 from line 3</td>
<td>$186,951</td>
</tr>
<tr>
<td>6</td>
<td>Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)</td>
<td>$186,951</td>
</tr>
<tr>
<td>7</td>
<td>Gross income. Add lines 5 and 6</td>
<td>$186,951</td>
</tr>
</tbody>
</table>

---

#### Part II: Expenses

**Enter expenses for business use of your home only on line 30.**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Advertising</td>
<td>$3,500</td>
</tr>
<tr>
<td>9</td>
<td>Car and truck expenses (see instructions)</td>
<td>$2,250</td>
</tr>
<tr>
<td>10</td>
<td>Commissions and fees</td>
<td>$2,500</td>
</tr>
<tr>
<td>11</td>
<td>Contractor labor (see instructions)</td>
<td>$2,500</td>
</tr>
<tr>
<td>12</td>
<td>Depletion</td>
<td>$2,500</td>
</tr>
<tr>
<td>13</td>
<td>Depreciation and section 179 expense deduction (not included in Part III) (see instructions)</td>
<td>$2,500</td>
</tr>
<tr>
<td>14</td>
<td>Employee benefit programs (other than on line 18)</td>
<td>$2,500</td>
</tr>
<tr>
<td>15</td>
<td>Insurance (other than health)</td>
<td>$2,500</td>
</tr>
</tbody>
</table>
| 16   | Interest:  
| a   | Mortgage (paid to banks, etc.) | $2,500 |
| b   | Other | $2,500 |
| 17   | Legal and professional services | $2,500 |
| 18   | Office expense (see instructions) | $2,500 |
| 19   | Pension and profit-sharing plans | $2,500 |
| 20   | Rent or lease (see instructions):  
| a   | Vehicles, machinery, and equipment | $2,500 |
| b   | Other business property | $2,500 |
| 21   | Repairs and maintenance | $2,500 |
| 22   | Supplies (not included in Part III) | $2,500 |
| 23   | Taxes and licenses | $2,500 |
| 24   | Travel, meals, and entertainment:  
| a   | Travel | $2,500 |
| b   | Deductible meals and entertainment (see instructions) | $2,500 |
| 25   | Utilities | $2,500 |
| 26   | Wages (less employment credit) | $2,500 |
| 27   | Other expenses (from line 48) | $2,500 |
| 28   | Reserved for future use | $2,500 |

**Total expenses** for business use of your home before expenses for business use of your home. Add lines 8 through 27a.  
**Tentative profit or (loss).** Subtract line 28 from line 7.

---

**Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions).**

**Simplified method filers only:** enter the total square footage of: (a) your home; and (b) the part of your home used for business. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30.

**Net profit or (loss).** Subtract line 30 from line 29.

- If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3.
- If a loss, you must go to line 32.

**32a** All investment is at risk. **32b** Some investment is not at risk.
Schedule C: Profit or Loss from Businesses

On Page One of the 1040 you’ll find Business Income: Line 12. You should have circled the $42,598 on page one and detoured here.

Circle the $42,598 on Schedule C when you find it. If the total at the bottom of Schedule C is different, look for more Schedules C.

**Watch For**

Dropping taxable business income could be caused by the timing of receipts in a cash-basis borrower or depreciation on purchase of new equipment.

1/ Gross receipts

11/ Part of the workforce although paid as independent contractors

13/ If an equipment list is included, look at type and amount of equipment and whether the age of the equipment seems consistent with an ongoing healthy business of this type.

**Watch For**

Watch for sell-off of equipment that is critical to operations of the business.

16/ You need a debt list from the borrower. You may already have this clearly identified on their application.

**Watch For**

Sole Proprietors regularly mix personal debt and business debt on their application.

20b/ The business pays this to the landlord for rent. It can give you an idea of the size of space they are in.

26/ This and Line 37 give an idea of the number of employees in addition to the owner. Consider if other family members are working without payment.

**Overview**

If you are doing a commercial loan to this company or a personal analysis where this is a significant cashflow source, this overview list can give you a good feel for the business. Spot significant nonrecurring items, fraud or an important change in the business.

**Name/ Who is the sole proprietor?**

A/ Type of Business

C/ Look for LLC after name, indicates limited liability.

F/ Accounting method. [If cash basis, you cannot as easily compare to other years. A change in revenues could be caused by the timing of customer’s payments near year-end rather than a declining or growing business.]

**BASICS**

**Significant source of repayment/risk?**

If not, here are the basics:

13/ Add back depreciation.

16/ Add back interest. 1) Subtract debt for net cash flows or 2) Put on debt list for debt coverage or 3) Some mortgage lenders: No debt adjustment but do not include business debt on personal list. Interest on vehicle debt may be included on Line 9 but generally is on Line 16.

24b/ Subtract disallowed meals.

30/ Add back home office.

**To Do**

Both methods: Enter Borrower Name, Prepared by, Business name and type, and Year on the Sole Proprietorship Schedule C Worksheet.

S/A Method enter Line 31 Net Profit from Schedule C.

AGI Method do not enter Net Profit already in AGI.

Turn the page for Line-by-Line notes on calculating the cashflow from Schedule C.
CASHFLOW THE SCHEDULE C:

Tip
For an in-depth analysis, use the roadtrip method and follow line-by-line down Schedule C.

With the roadtrip approach, you will know where to come back to when interrupted.

LINE-BY-LINE NOTES:
If you are doing a cursory analysis because the Schedule C cashflow is not material or because the borrower can qualify easily without it, at least cover the basics...Line 13, 16, 24b and 30.

ADVERTISING: LINE 8
Significant decrease in this or any other discretionary expense may indicate cashflow problems.

Watch For
‘Discretionary’ expenses are one of the first places cut back if times are tough.

Don’t jump to conclusions, though. There can be a reasonable explanation. Watch for a pattern.

CAR & TRUCK: LINE 9
There often is no adjustment to this number. Line 9 may also include interest expense to add back. Some lenders add back 1/3 of Line 9 if it is mileage allowance since that represents depreciation.

Tip
The back of Form 4562 may indicate what vehicles were used for business and if it was mileage.

Digging for Dollars
Check to see if Line 9 includes car interest expense. If so, you may be able to add that back if you are subtracting the entire car loan payment elsewhere.

DEPRECIATION: LINE 13
This is a noncash entry and generally, no check was written. The only exception is for businesses with sufficient cashflow that they buy major equipment and do not finance it. This is rare enough that we usually don’t worry about it.

Line 13 comes from Form 4562 Depreciation Schedule. However, that form is not required when no equipment has been purchased during the tax year.

Watch For
If the Form 4562 is missing both years and you seem to have a complete tax return otherwise, consider if it seems reasonable for a healthy business of this type to go two years without replacing equipment. Form 4562 provides some helpful information.

To Do
Both methods add back the $5,727 depreciation. Then circle depreciation on Schedule C and let’s trace it to the 4562 on page 42.

INSURANCE: LINE 15
Most companies need some sort of insurance. Here is a line that ‘should’ have an entry.

Watch For
No insurance or woefully inadequate insurance. In general, we ignore blank lines when reviewing a tax return. This is a line that should not be blank.
INTEREST: LINE 16  
Where there is interest expense, there are (or were) debt payments. However, the amount of the debt payments and their duration is nowhere to be found.

Check the borrower’s application or perhaps their credit report to spot the debt. Keep in mind that a sole proprietor’s business debt may be mixed in with their personal debt.

Watch For
Take great care that you do not subtract business debt here and also include it in their personal debt.

To Do
Add back $2,633 interest on the worksheet and question debt. If Line 9 is significant and they have a car loan, ask if there is interest in Line 9 to add back as well. Write ‘Q1’ on term debt line of worksheet.

LEGAL AND PROFESSIONAL SERVICES: LINE 17
This includes accounting as well as legal.

Watch For
A huge jump could mean a lawsuit. Or it could mean they finally hired an accountant or had their lawyer rewrite all their contracts.

If a lawsuit is in progress, consider what is the worst that can happen. Is it limited to losing money that will not harm them?

If a loss will damage the viability of their business proceed with caution.

PENSION AND PROFIT SHARING: LINE 19
This line is used to report both required payments into pension plans as well as totally optional profit sharing payments.

Digging for Dollars
If it is profit-sharing you may be able to add it back as nonrecurring.

REPAIRS AND MAINTENANCE: LINE 21
Changes in this expense should make sense given the age and type of their equipment.

Watch For
A large decrease here could be a hint of trouble. It may not be a concern, however, if they have replaced equipment or did a lot of preventative maintenance last year.

Digging for Dollars
If the business suffered from a natural disaster or a fire last year, there may be significant nonrecurring expenses here. Compare to the previous year.

TAXES AND LICENSES: LINE 23
This line includes real estate taxes, professional licenses and payroll taxes.

Watch For
If they are not paying enough of these, they are in trouble. Calculate estimated payroll taxes. 10% of wages (Line 26) is a minimum and for high-risk jobs can go up to 40% of wages.

DISALLOWED MEALS: LINE 24B
On Line 24b they have deducted 50% of the out-of-pocket expenditures for meals and entertainment. We’ll subtract the ‘other’ 50%.

To Do
Subtract $460 on Schedule C worksheet.

WAGES: LINE 26
This should not include wages to the owner of the company. I would say ‘does not’ but I actually saw it once.

CONTINUE ON PAGE 2-27 ...
Look for noncash (amortization) and nonrecurring expenses to add back. Most important when you are Digging for Dollars.

You may spot nonrecurring expenses because of what they are called (moving expenses) or by comparing two year’s (or more) tax returns.

Check your guidelines before adding back nonrecurring expenses. If your company uses historical cashflow, mention significant nonrecurring expenses or losses in the write-up rather than adding them back.

| 48 | Total other expenses. Enter here and on line 27a | 48 | 15,951 |
PART III: COST OF GOODS SOLD
Retail stores write off the cost of the good sold.

When there is inventory, compare Line 35, inventory at the beginning of the year to Line 41, inventory at the end of year. Generally, inventory should be growing if sales are growing.

Watch For
Fast-growing companies are higher-risk, in general, than stable companies.

Line 37 will include wages, employee benefits, and payroll taxes of employees who work directly on inventory. This is in addition to the wages reported on Page One of the Schedule C, and like that wage figure, it should not include compensation to the owner. Subcontractors will also be included on Line 37.

PART V: OTHER EXPENSES
You get here by circling the $15,951 on Line 27 on the front page of Schedule C and tracing it to its source.

Check for amortization and nonrecurring expenses to either add back or note in your “write-up”.

Digging for Dollars
Compare to prior year to find significant nonrecurring expenses to add back. I thought the Paris Trip seemed unusual for a retail store. If I were digging for dollars, I’d ask about it.

To Do
Write a question about the Paris Trip.

Enter ‘Q2’ on your worksheet under ‘additional adjustments’.

Put a checkmark on the bottom of Page Two of Schedule C since we have finished its review.

Turn back to the front page of Schedule C (page 22).

WHAT’S NEXT?
We cannot continue with the Schedule C worksheet until we get answers to questions.

To Do
For now, put a check mark on the bottom of Schedule C (page 22) to show that we have finished reviewing it, made the entries that we can and have noted any questions.

Then go back to Page One of the 1040 tax return (page 10) to go on with our review.
# Form 6252: Installment Sale Income

## Part I: Gross Profit and Contract Price

Complete this part for the year of sale only.

<table>
<thead>
<tr>
<th></th>
<th>Description of property</th>
<th>Date acquired (mm/dd/yyyy)</th>
<th>Date sold (mm/dd/yyyy)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3. Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4.

4. Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No,"
complete Part III for the year of sale and the 2 years after the year of sale.

## Part II: Installment Sale Income

Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

<table>
<thead>
<tr>
<th></th>
<th>Selling price including mortgages and other debts. Do not include interest, whether stated or unstated</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

6. Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions).

7. Subtract line 6 from line 5.

8. Cost or other basis of property sold.

9. Depreciation allowed or allowable.

10. Adjusted basis. Subtract line 9 from line 8.

11. Commissions and other expenses of sale.

12. Income recapture from Form 4797, Part III (see instructions).

## Part III: Related Party Installment Sale Income

Do not complete if you received the final payment this tax year.

<table>
<thead>
<tr>
<th></th>
<th>Name, address, and taxpayer identifying number of related party</th>
</tr>
</thead>
<tbody>
<tr>
<td>27</td>
<td></td>
</tr>
</tbody>
</table>

28. Did the related party resell or dispose of the property ("second disposition") during this tax year? Yes No

29. If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.

   a. The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy).

   b. The first disposition was a sale or exchange of stock to the issuing corporation.

   c. The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

   d. The second disposition occurred after the death of the original seller or buyer.

   e. It can be established to the satisfaction of the IRS that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30. Selling price of property sold by related party (see instructions).

31. Enter contract price from line 18 for year of first sale.

32. Enter the smaller of line 30 or line 31.

33. Total payments received by the end of your 2014 tax year (see instructions).

34. Subtract line 33 from line 32. If zero or less, enter -0-.

35. Multiply line 34 by the gross profit percentage on line 19 for year of first sale.

36. Enter the part of line 35 that is ordinary income under the recapture rules (see instructions).

37. Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions).
This form is used to report income received in the form of payments from the sale of an asset, often real estate or a business. You should already have run across the interest received related to this contract on Schedule B: Interest Income.

**EXAMPLE:** You sold a rental house for $200,000 and you owned it free and clear. It cost $40,000 when you bought it. Your gain would be $160,000 even though you will get $200,000 in cash now.

If you report it on the installment basis, 80% of every dollar of principal received will be reported as gain. (Notice you are not paying taxes on every dollar received.)

**Line 21** represents PRINCIPAL payments received during the year. (The borrower received this amount in addition to the interest already reported on Schedule B.)

**Watch For**
You cannot assume, however, that this is a recurring amount. It may include down payments or balloon payments. It is best to request a copy of the contract from the borrower.

**AGI Method:** If there was a contract, you should already have subtracted the interest from the contract (Schedule B). Also be sure to subtract any gain reported on Schedule D Line 11. Then see ‘Both:’ below.

(You can wait until you decide on all the entries on Schedule D to make any entries or adjustments on your cashflow worksheet. If we decide to use none of it, we’ll add or subtract the net figure that hit the Page One of the 1040.)

**S/A Method:** You should not have included contract interest (Schedule B). Do not include the gain from installment sale contracts either. See ‘Both:’ below.

**Both:** Add the next twelve months payments if the contract is continuing long enough. You will get this information by asking the borrower.

**Tip**
If the contract will balloon out (be completely paid off with a substantial final payment) within the next several years, consider leaving some or all of the interest in income.

**QUICK AND DIRTY SHORTCUT:**
(I knew that would get your attention!) If you do not have detail on the contract and it was not entered into in the current year (see Line 2b), determine full payments received by adding interest from Schedule B for this contract to the principal received on Line 21.

**RECEIVING PAYMENTS AS AGREED?**
Add interest from Schedule B for this contract to principal from Line 21. Compare to what the contract says they should have received. (This is only worth your time if the contract payments are a significant source of income for the borrower.)

And finally, if they have more than one note/contract receivable you may also have numerous Forms 6252. You may not be able to tell which interest on Schedule B goes with which 6252.

No Form 6252 is required if the sale did not result in a taxable gain.
When you talk to your borrower, especially if it is a complicated return, see if they can have their copy of the return in front of them.

You are asking about things that happened two and three years ago and they may need help jogging their memory.

Write the name of the person to whom you spoke on the top of the worksheet so there is no confusion later. And if you got answers to different questions from different people, you can put their name and date in the response section instead.

**Tip**

When you are done with your call, provide the list of documentation you still need in writing. Frequently, what the borrower gives you is not exactly what you asked for.

In my experience, this is often the result of them misunderstanding or miswriting what you wanted.

Trust me, the borrower did not purposely spend time putting together things you did not need. Business owners do not have that kind of time.

**To Do**

If you are working through the analysis of the entire Fashion’s Tax Return, let’s assume that I have contacted the borrower and asked all the questions.

Turn the page and we will take them one at a time and make any adjustments necessary.
<table>
<thead>
<tr>
<th>Question #</th>
<th>Source of question:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>C16b</td>
</tr>
<tr>
<td>2</td>
<td>C48</td>
</tr>
<tr>
<td>3</td>
<td>E, Page One</td>
</tr>
<tr>
<td>4</td>
<td>E (D St) Line 18</td>
</tr>
</tbody>
</table>

**Question # 1**

**Question for whom:** Borrower

**Question/Item:** Interest expense of $2,633. How much are the payments? How long will they continue? Add back interest from line 16b. If continuing more than X months, subtract annual debt. (FNMA do not add back interest or subtract debt. Check that you do not have this payment in the debt list.) (Global Debt Coverage approach: Add back interest and put debt on debt list.)

**Documentation needed:** Creditor Statement or confirm to credit report.

**Response:** The Dodge Caravan is paid off. We have an equipment loan with payments of $667.36/month with two years left to go.

---

**Question # 2**

**Question for whom:** Borrower

**Question/Item:** Paris trip of $9,255. Is this a usual expense? Add back if nonrecurring.

**Documentation needed:**

**Response:** One time trip. Nonrecurring.

---

**Question # 3**

**Question for whom:** Borrower

**Question/Item:** Do you still own all rentals? Any new ones? If payment is needed (formula method or refinance), what are the payments and are they PI only or PITI? Have the rents increased significantly? For new properties, what are the scheduled monthly rents? If you sold any rentals, did you carry contracts?

**Documentation needed:** Signed leases, copies of contracts, REO form, credit report

**Response:** Sold 3rd street and did not carry contract.

Have owned D Street for five years. Payments are $550/month PI only. We refinanced last year. Jade Street is new. Rents are $910/month and payments are $895/month.

---

**Question # 4**

**Question for whom:** Borrower

**Question/Item:** $4,580 water system assessment. Is it continuing? If not, add back as nonrecurring expense.

**Documentation needed:**

**Response:** Our (tank) bladders were leaking and the well house needed a new roof. We did the work and the three homes on the community well shared in the expense. It is all paid.
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Ask Linda
She’ll always answer. Give her a week to get back to you, because she is likely on the road helping lenders say ‘yes’ to good loans.

“I love the step-by-step approach of your manuals. You take the numbers and explain what they are, why you use them or not, what schedule you look at to find the details of where than number came from and how they tie into the overall cash flow analysis.”

Dorothy Wenker, Commercial Lender
MidSouth Bank

It’s great to work at my own pace since the course allows you to stop, review, and go back over items you may not have understood the first time around. A very helpful feature!

Linda Wiley, Pacific Western Bank

“Linda has been extremely helpful with various questions I have had over the years. If I am ever stumped on a question in regards to cash flow, I am confident I can go to her and will receive an accurate, prompt and friendly response. Linda is a fantastic resource to have.”

Ryan Earl, Senior Credit Analyst
Heritage Bank

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