

The C's of Credit Guidelines for Tax Return Analysis

February 24, 2016

PRESENTED BY



Linda Keith
Linda Keith CPA Inc.

About Sageworks.



- Loan portfolio and risk management solutions
- More than 1,000 financial institution clients
- Founded in 1998
- Risk management thought leader for institutions and examiners
- Featured in national and trade media

THE WALL STREET JOURNAL  AMERICAN BANKER



About Linda Keith CPA

Linda Keith CPA Inc. is a niche practice serving financial institutions' credit analysis training needs. Linda focuses on the loan quality side of the risk management equation.

Her programs on Tax Return Analysis cover **Business Lending**, **Agriculture Lending** and **Personal Lending to Complex Borrowers** and are delivered in-person and virtually through www.LendersOnlineTraining.com.

Her clients hire her internally or send loan officers, underwriters and analysts to open-enrollment sessions. Through Linda's training, they advance to

- Understanding the borrower's business
- Spotting red flags and asking good questions
- Making good decisions and documenting the file

For in-house clients, Linda advises on guidelines to customize the training. Today, she'll share her observations of over 25 years working with financial institutions.



Business Lending



Agriculture Lending



Complex Borrowers



ALLL TDR STRESS TESTING CREDIT ANALYSIS RISK RATING LOAN PRICING LOAN ADMINISTRATION WORKFLOW



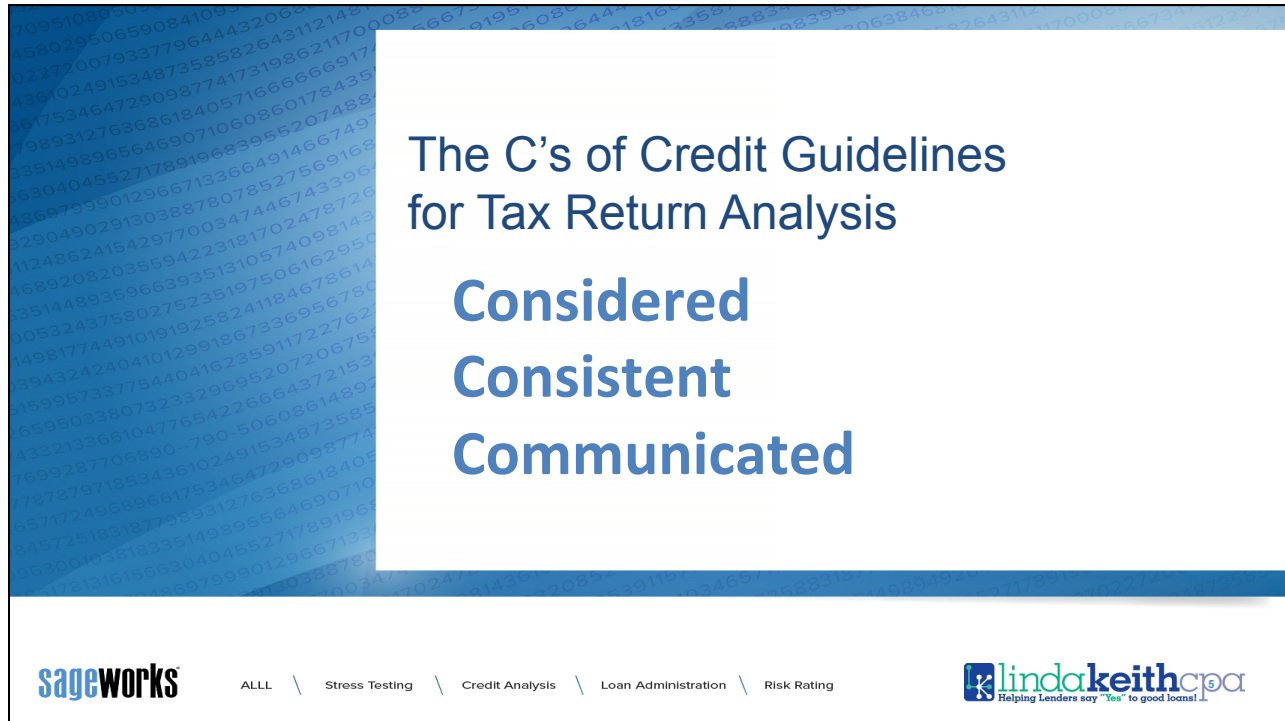
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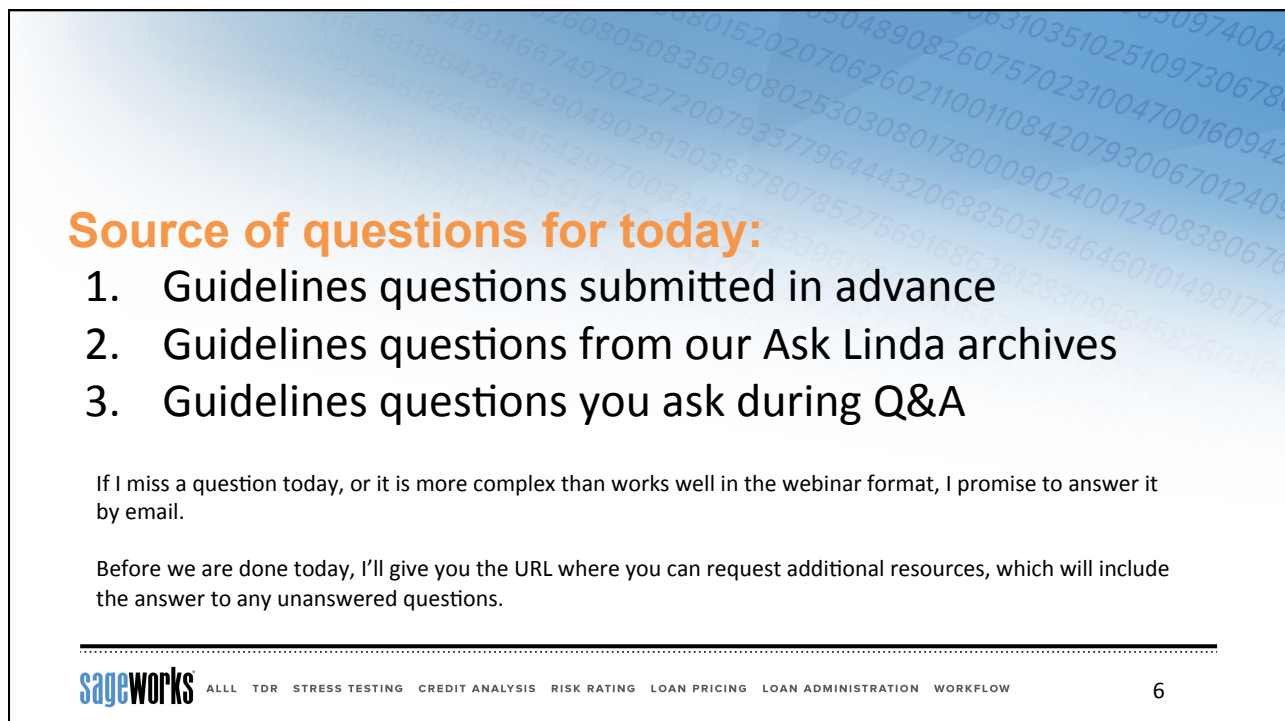
ALLL TDR STRESS TESTING CREDIT ANALYSIS RISK RATING LOAN PRICING LOAN ADMINISTRATION WORKFLOW



The C's of Credit Guidelines
for Tax Return Analysis

Considered
Consistent
Communicated

sageworks ALLL \ Stress Testing \ Credit Analysis \ Loan Administration \ Risk Rating  Helping Lenders say "Yes" to good loans!




Source of questions for today:

1. Guidelines questions submitted in advance
2. Guidelines questions from our Ask Linda archives
3. Guidelines questions you ask during Q&A

If I miss a question today, or it is more complex than works well in the webinar format, I promise to answer it by email.

Before we are done today, I'll give you the URL where you can request additional resources, which will include the answer to any unanswered questions.

sageworks ALLL TDR STRESS TESTING CREDIT ANALYSIS RISK RATING LOAN PRICING LOAN ADMINISTRATION WORKFLOW 6




Global Analysis and DCR

- Best practices for determining living expenses for global DCR
- When to consider business cashflow in with global.
- Treatment of Personal Debt

Pass-Thru Entities

- Royalties on Schedule E and the K-1: Duplicate?
- Is it okay to leave pass-thru income/loss out when we cannot get the tax returns or K-1s?
- What about missing k-1s? **Passive vs NonPassive**
- How do I avoid double-counting?

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Depreciation, Owner Capital

- How to handle Section 179 depreciation generally, and it's impact on evaluating owner's capital.

Qualifying Income

- Can we lend on asset conversion or do we have to stick with income?
- Can I use potential capital gains from sale of stock, even though the prospective borrower has not sold any in the last three years?

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Global Analysis

How do you define Global Cashflow?

- Personal Analysis:**
- 1) Combine the personal cashflow with the available cashflow from the entities with high enough % ownership. OR
 - 2) Combine the personal cashflow with the actual cashflow from owned entities.



Global Analysis

How do you define Global Cashflow?

- Business Analysis**
- 1) Combine the business cashflow with the personal cashflow from all guarantors (including their available cashflow from other owned entities). OR
 - 2) Combine the business cashflow with the personal cashflow from all guarantors, only using the actual cashflow from other owned entities.



Global Analysis

Do you net the personal debts prior to calculating DCR?

In my experience, most lenders put all debt on the global debt list. However, you'll get a different answer if you subtract personal debt first, then do a DCR.

Question: If you are only counting the owner/guarantor's actual cashflow from an other owned entity, do you count any of that entities debt against the owner cashflow?

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Global Analysis

When is a business loss added or not added back to personal income when calculating global DSC?

Guidelines vary.

- 1) Is the business obligated on the loan?
- 2) If not, is it owned by an owner who is obligated on the loan? If yes, a share of the business cashflow (positive or negative), may be bundled into the global cashflow.

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Global Analysis

What are prudent living expense allowances? Is there a good source?

Should a lender also consider Schedule A itemized deductions?

There is no consistent guideline. Consider:

- 1) Number in the family
- 2) Overall level of income
- 3) Expensive toys or hobbies
- 4) If AgLending, whether they live on the farm
- 5) Earned Net Worth Change

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Depreciation – Section 179

How do most banks treat 179 Depreciation Expense?

I've seen it done different ways.

If you are going to add it back anyway, I would ignore it completely. Especially with pass-thru entities, it is not on the front page and is easy to miss. I generally recommend you add back only the depreciation that was subtracted from taxable income.

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Depreciation – Section 179

How do you evaluate capital with a manufacturing company that takes significant section 179 depreciation?

When I want to evaluate capital, I do it with something other than a tax return. Use appraisals or consider requiring accrual basis, CPA-prepared financial statements.

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Unreported Income, Character

If I become aware that the prospective borrower has not reported income on their tax return, should I try to qualify them without it or find a way to decline the loan?

Personal and Mortgage lenders often tell me they will make the loan if they can find enough, documentable income. Business lenders generally say no.

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**Rentals, LLCs, Disallowed Losses
Performing vs Qualifying**

Which loss figures do we use from the rental schedule (1040 E, Page One)?
There are two.

Use the loss before limitations, not the bottom line.


The easiest way to do this is to go to the top of the form, add the income, subtract the expenses, and then add back depreciation and, if appropriate, the interest expense.

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Resources

- + **Guidelines Checklist (Excel, Customizable)**
- + Recordings of and resources from this and previous Sageworks Webinars
 - + Multiple Pass-Thru Entities
 - + Red Flags and Green Lights in Tax Returns: Extended Handouts
- + Sign-up for 'Ask Linda' monthly email



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Pass-Thru Entities



Royalties on Schedule E and the K-1: Duplicate?

Is it okay to leave pass-thru income/loss out when we cannot get the tax returns or K-1s?

What about missing k-1s?

How do I avoid double-counting?

Do I use K-1 cashflow or share of company cashflow in owner/guarantor analysis?

Does the difference between passive and nonpassive influence the cash flow of the borrower?

Do we count distributions from Schedule K against the company?

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Schedule E (Form 1040) Attachment Sequence No. 13 Page 2

Name(s) shown on return. Do not enter name and social security number if shown on Page 1. Your social security number

Linda Gabbert & Frank Able 121-21-2121

Part II Income or Loss From Partnerships and S Corporations

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? Yes No

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
	Able Baker Book Store	P	<input type="checkbox"/>	10-9876543	<input type="checkbox"/>
	Odds N Ends Medical Clinic	S	<input type="checkbox"/>	91-9999999	<input type="checkbox"/>

Passive Income and Loss		Nonpassive Income and Loss		
(f) Passive loss allowed (attach Form 8582 if required)		Nonpassive Income and Loss		
A	(h) Nonpassive loss from Schedule K-1	(i) Section 179 expense deduction from Form 4562	(j) Nonpassive income from Schedule K-1	
			62,980.	180.
			24,999.	99.
29a Totals		2,880.	24,999.	179.
b Totals				
30 Add columns (g) and (j) of line 29a				67,979.
31 Add columns (f), (h), and (i) of line 29b				
32 Total partnership and S corporation income or (loss). Combine lines 30 and 31. Enter total in the total on line 41 below				85,099.

We'll find this on 1040, Page one. ➔

40	
41	85,099.

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1040 Line 17

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	80,000.
8 a	Taxable interest. Attach Schedule B if required	8 a	1,400.
b	Tax-exempt interest. Do not include on line 8a	8 b	600.
9 a	Ordinary dividends. Attach Schedule B if required	9 a	
b	Qualified dividends (see instrs)	9 b	
10	Taxable refunds, credits, or offsets of state and local income taxes (see instructions)	10	
11	Alimony received	11	30,000.
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Att Sch D if reqd. If not reqd, ck here	13	
14	Other gains or (losses). Attach Form 4797	14	
15 a	IRA distributions	15 a	
b	Taxable amount (see instrs)	15 b	
16 a	Pensions and annuities	16 a	
b	Taxable amount (see instrs)	16 b	999.
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	999.
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20 a	Social security benefits	20 a	
b	Taxable amount (see instrs)	20 b	
21	Other income	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your total income	22	196,499.

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Pass-Thru Entities 1040 Schedule E, Page Two

What is actual cash inflows on Schedule E Income?

There are no actual cash inflows on Schedule E. You will need the K-1 to determine actual cash inflow.

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Pass-Thru Entities
1040 Schedule E, Page Two

Do you utilize the Schedule E income reported in AGI or do you get K-1s to determine distributions and contributions?

There are no actual cash inflows on Schedule E. You will need the K-1 to determine actual cash inflow.
That said, another option is to determine what the owner has available to them.

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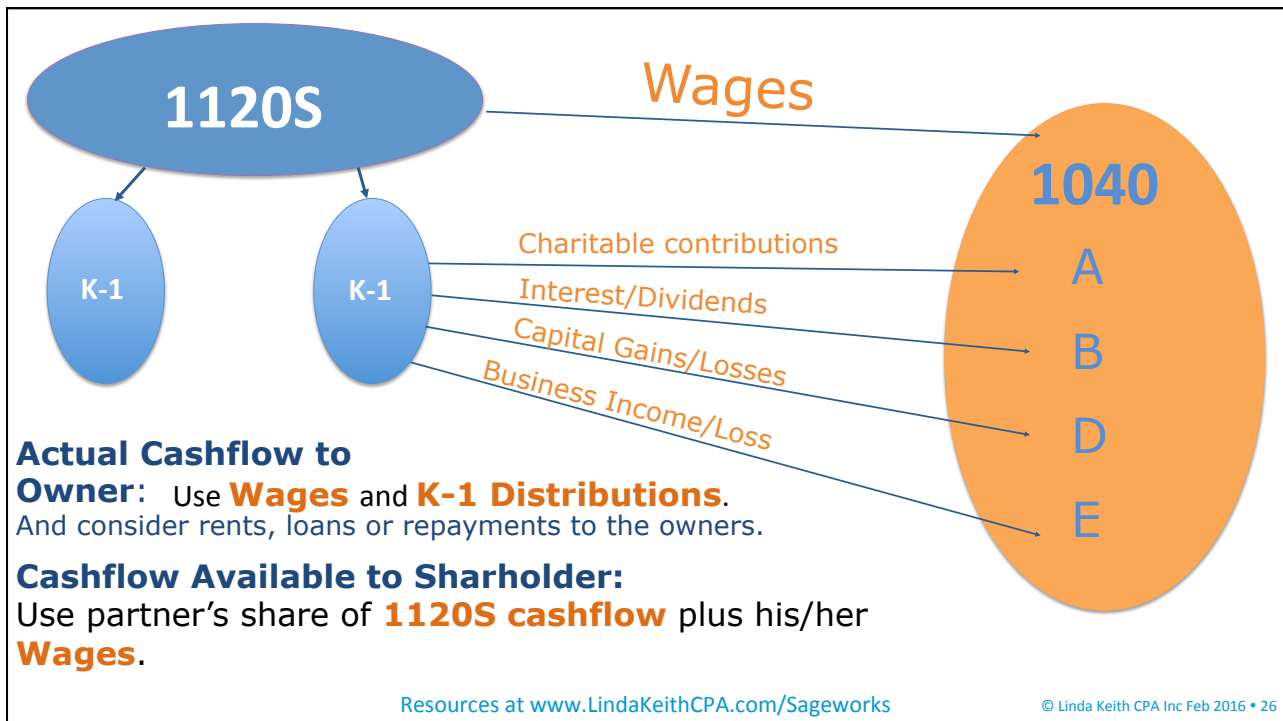
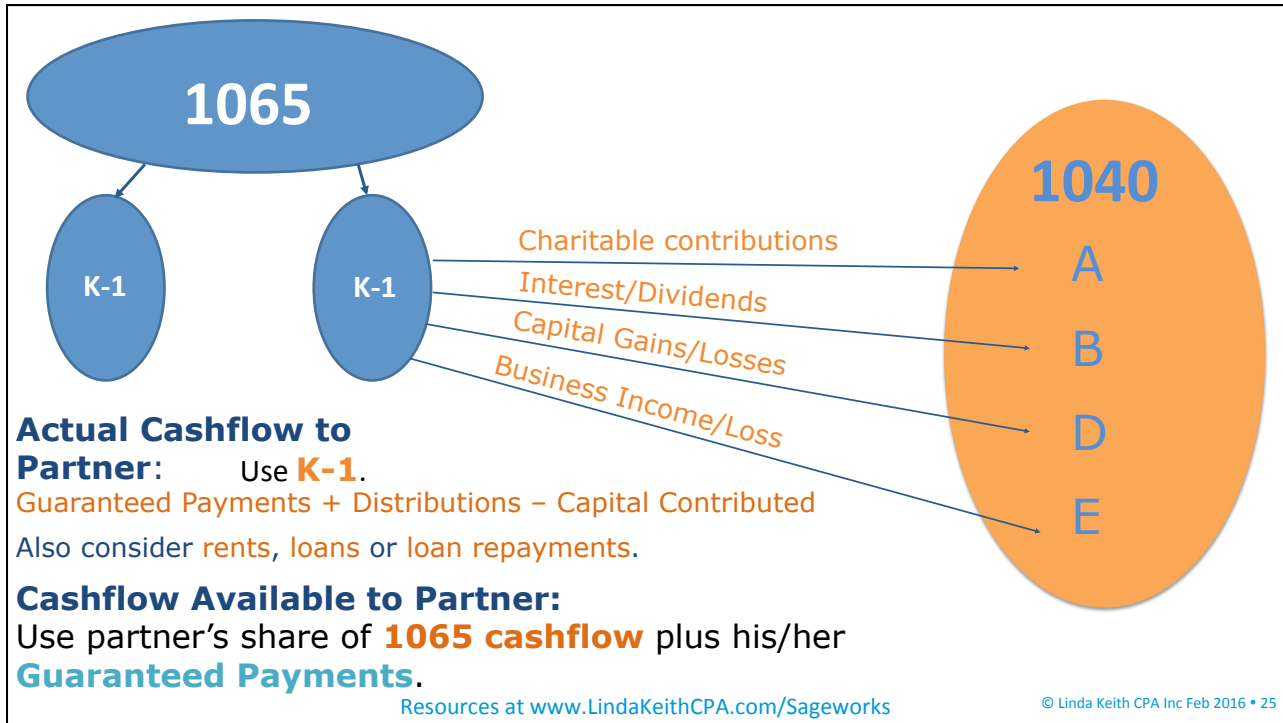
Pass-Thru Entities
1040 Schedule E, Page Two

Should we ignore 1040, Schedule E, Page Two completely?

Pretty much! At least as it relates to the numbers listed. It is good for:

- A list of the entities partially owned
- An indication of what type of return to request
- A clue as to whether the owner is active in the business

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Pass-Thru Entities
Double Counting

Should we count K-1 Interest listed on
Schedule B?

Probably not. If you want to give the pass-thru entity
credit for the interest income, do it in the company
analysis.

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Pass-Thru Entities
Double Counting

On Schedule B of the 1040, does the
accountant have to note whether the
interest is K-1 pass through or interest
actually paid to the individual from a
pass through entity.

- Some software indicates 'K-1 Interest Income'.
- Some lists the entity name and you cannot tell.
- Once you have the K-1, you can tell.

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Pass-Thru Entities
Double Counting

Royalties that are on a K1 are also listed on Schedule E page one. Did the individual/business actually receive the royalties?

Nothing on the K-1 that passes through to the 1040 is cash actually received.

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Pass-Thru Entities
Missing K-1s

I have a customer with multiple K-1's listed on his tax return that were not attached. I asked for all of them. He is stating that several of them are investments and he did not receive a K-1. Is that possible?

The K-1s exist. Either the borrower received them digitally and they went right to the preparer, or they are investment type K-1s and do not look like a K-1.

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**Pass-Thru Entities
Missing K-1s**

We are not always able to obtain a pass-through entity tax return or K-1. I typically exclude all pass-through income or loss from that entity in the individual's cash flow. I make it clear to the reader that no cash flow from that entity was included due to lack of information. Thoughts?

Your guidelines need to tell you if you must obtain the K-1s. Excluding the pass-through income or loss makes me very nervous. You have no idea what impact the outside business is having. It may be bleeding them dry.

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Pass-Thru Entities – Passive vs NonPassive



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Schedule E (Form 1040) Attachment Sequence No. 13 Page 2
Name(s) shown on return. Do not enter name and social security number if shown on Page 1. Your social security number
Linda Gabbert & Frank Able 121-21-2121


Part II Income or Loss From Partnerships and S Corporations
Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.
Note: If you report a loss from an at-risk activity for which any amount is not at risk, you must check the box in column (e) on line 28 and attach Form 6198. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? Yes No
If you answered 'Yes,' see instructions before completing this section.

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
A	Able Baker Book Store	P		10-9876543	
B	Odds N Ends Medical Clinic	S		91-9999999	
C					

Passive Income and Loss		Nonpassive Income and Loss		
(f) Passive loss allowed (attach Form 8582 if required)	(g) Passive income from Schedule K-1	(h) Nonpassive loss from Schedule K-1	expense deduction from Form 4562	Passive income from Schedule K-1
A				62,980.
B			2,880.	24,999.
C				
29				87,979.
b Total			2,880.	
30	Add columns (g) and (i) of line 29a			30 87,979.
31	Add columns (f), (h), and (j) of line 29b			31 -2,880.
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31. Enter the result here and include in the total on line 41 below			32 85,099.

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Pass-Thru Entities
Passive vs NonPassive

Does the difference between passive and nonpassive influence the cash flow of the borrower?

Yes. Passive means investor. Your guidelines may allow you to ignore smaller amounts in this category.
Nonpassive means active business. This individual is more likely to have guaranteed debt and/or be a high percentage owner.

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Pass-Thru Entities
Passive vs NonPassive

Do we treat passive and non-passive income/losses different in our analysis?
Is the documentation required the same or different?

Some lenders treat passive different than nonpassive. Others treat them the same.

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Pass-Thru Entities
Passive vs NonPassive

My borrower shows \$7,000 non-passive income in one year and \$42,000 passive income the next year from the same company.


Should I use both and average?

Maybe. If the return was done correctly, they have switched from active owner to investor. I'd want to understand this a bit better.

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Pass-Thru Entities
Personal Cashflow



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Actual Personal Cashflow Partner/LLC Owner



Schedule K-1
(Form 1065)
Department of the Treasury
Internal Revenue Service

Partner's Share of Income, Deductions, Credits, etc. ▶ See separate instructions.

Part I Information About the Partnership
A Partnership's employer identification number
10-9876543
B Partnership's name, address, city, state, and ZIP code
Able Baker Book Store

L Partner's capital account analysis:
 Beginning capital account \$ 14,050.
 Capital contributed during the year \$
 Current year increase (decrease) \$ 32,663.
 Withdrawals and distributions \$ 25,910.
 Ending capital account \$ 20,803.

Tax basis
 GAAP
 Section 704(b) book

Final K-1
 Amended K-1

Part III Partner's Share of Income, Deductions, Credits, etc.

1	Ordinary business income (loss)	32,980.
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4	Guaranteed payments	30,000.
5	Interest income	75.
6 a	Ordinary dividends	
6 b	Qualified dividends	
7	Royalties	
8	Net short-term capital gain (loss)	
9 a	Net long-term capital gain (loss)	

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Actual Personal Cashflow S Corporation Shareholder



Schedule K-1 (Form 1120S) Department of the Treasury Internal Revenue Service		<input type="checkbox"/> Final K-1 <input type="checkbox"/> Amended K-1	671112 OMB No. 1545-0130
Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items			
1	Ordinary business income (loss)	13	Credits
	24,999.		
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
	942.		
5 a	Ordinary dividends		
5 b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		

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Part I Information About the Corporation		4	Interest income	942.		
A	Corporation's employer identification number 91-9999999	5 a	Ordinary dividends			
B	Corporation's name, address, city, state, and ZIP code Odds N Ends Medical Clinic PO Box 1234 Santa Ana, CA 92701	5 b	Qualified dividends	14	Foreign transactions	
C	IRS Center where corporation filed return Ogden, UT 84201-0013	6	Royalties			
Part II Information About the Shareholder		7	Net short-term capital gain (loss)			
D	Shareholder's identifying number 987-65-4321	8 a	Net long-term capital gain (loss)			
E	Shareholder's name, address, city, state, and ZIP code Linda S Gabbert 1000 N 15th St Santa Ana, CA 92701	8 b	Collectibles (28%) gain (loss)			
F	Shareholder's percentage of stock ownership for tax year 60.0000 %	8 c	Unrecaptured section 1250 gain			
		9	Net section 1231 gain (loss)			
		10	Other income (loss)	15	Alternative minimum tax (AMT) items	
		11	Section 179 deduction	2,880.	16	Items affecting shareholder basis
		12	Other deductions		D	38,594.

FOR IRS USE

D!
E?

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\$4,999

Paid taxes on her share of taxable income.

Available Personal Cashflow to owner

50,509

\$38,594

Actual Additional Cashflow to owner

Guidelines based on:

- Pattern
- % Ownership

Lenders consider:

- Guidelines
- Common Sense
- Judgment

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Say "Yes" to good loans!

Using Business Returns to qualify your borrower is covered in a series of 9 modules with handouts at www.LendersOnlineTraining.com


11205 1) Basics and Overview (06/21/11:05)
Course Introduction | Resources

11205 2) Company Cashflow (06/21/11:05)
Course Introduction | Resources


11205 3) Owner Cashflow (06/21/11:05)
Course Introduction | Resources

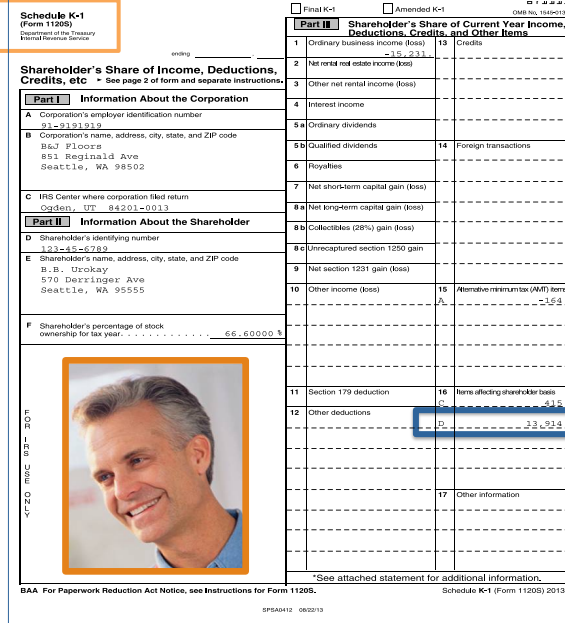
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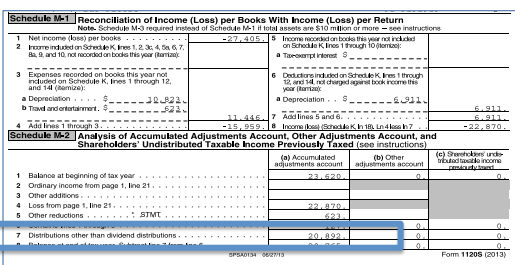
Pass-Thru Entities
Company Cashflow



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The company paid out \$20,892 in distributions


If you are not requiring the other owners to guarantee you need to

- 1) subtract the extra \$6,978 from company cashflow OR
- 2) Subtract the \$20,892 from company cashflow and add the \$13,914 to personal cashflow.

The company paid Ben \$13,914 in distributions

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Pass-Thru Entities

Do you add back contributions from the owners to the business when calculating the global?

Do you consider whether the contributions are typical before adding them to company cashflow?

If you subtract all distributions, you likely should add back all contributions.
If you are calculating recurring cashflow, and the contributions are one-time contributions (to buy equipment or pay down debt), think twice.

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Pass-Thru Entities

We just subtract the full distributions charged against the Schedule K.
Is this an incorrect assumption?

Does it change if not all owners are included in the global analysis?

If all owners are also guarantors and included in the global analysis, you do not need to do this.
If you do not include all owners in the global analysis, then you need to subtract all distributions at the company level, but add distributions to the owner/guarantors.

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**Ben, Jan and Zac own B&J Floors.
Dan is Jan's husband.**

- B&J Floors files an 1120S.
- Odds N Ends Clinic files an 1120S.
- Valley Vineyards LLC files a 1065.
- The Donut Shop files an 1120S.

```
graph LR; B["B&J Floors:  
Borrower"] --- Ben["Ben 67%"]; B --- Jan["Jan 25%"]; B --- Zac["Zac 8%"]; Ben --- O["100% Odds N Ends Medical"]; Jan --- V["Dan: 90% Valley Vineyards"]; Jan --- D["Dan: 10% Donut Shop"];
```

Based on your guidelines, how many 1040, 1065 and 1120S returns you will request?

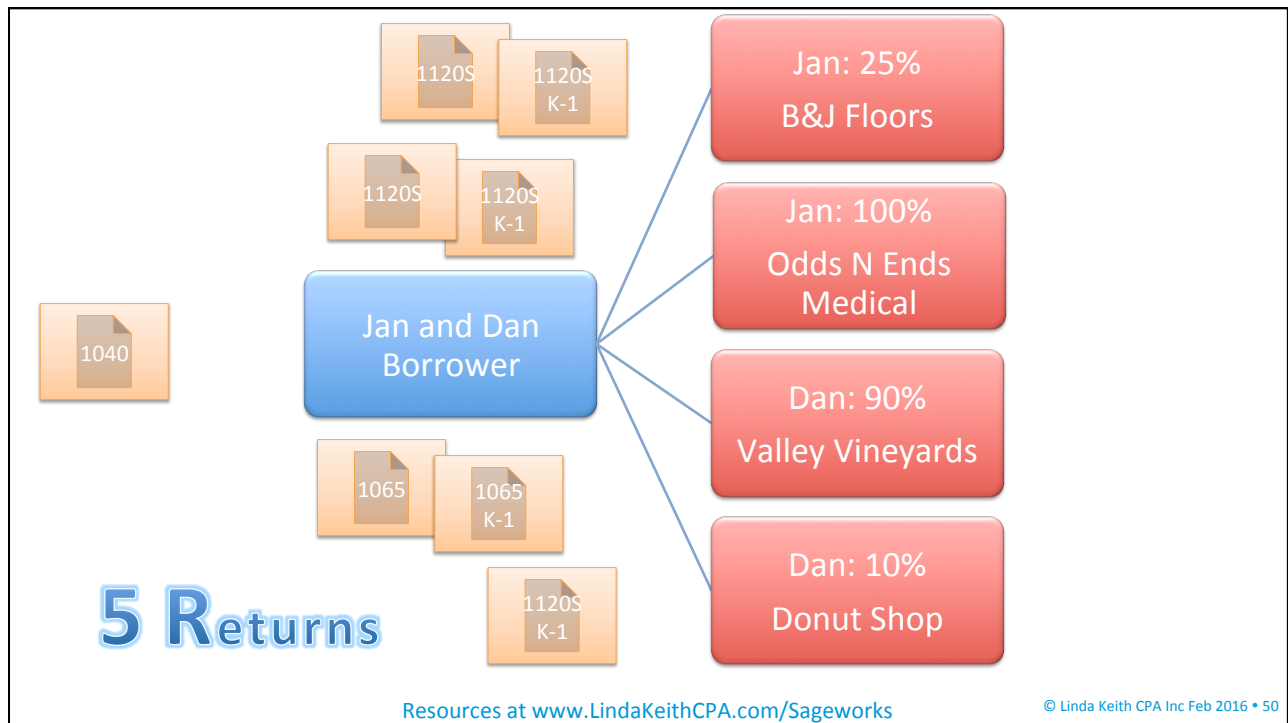
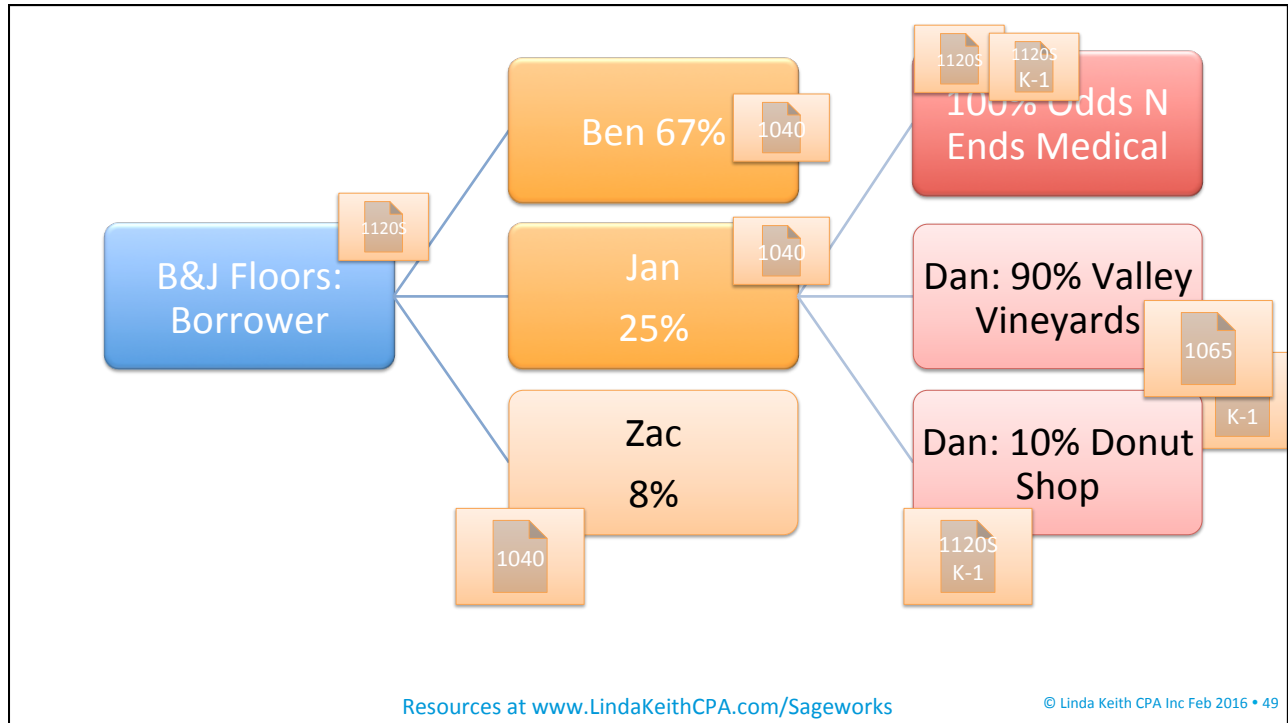
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Poll Question


Assuming a global analysis, and counting each 1040, 1065 and 1120S as a separate return, how many returns will you require based on your guidelines?

- Two returns
- Four returns
- Five returns
- Seven returns
- Something else

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Treatment of Taxes



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Treatment of Taxes



When you deviate from personal AGI for cash flow, how would you make adjustments to personal tax liability?

For recurring cashflow:
Consider only major changes for nonrecurring items (ie large capital gains)
Reduce taxes if not counting large gain. Increase taxes if not counting large expense.

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Treatment of Taxes

We subtract federal taxes for cashflow purposes but do not reduce that by tax credits.
Are we counting too much against them?


Most lenders do not reduce the taxes by the tax credits. However, if they have a significant, recurring tax credit, I'd give it a try.

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Qualifying Income



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Qualifying Income

Do we lend on asset conversion or do we have to stick with income?

All retired people are living on asset conversion if they were able to save and invest sufficiently for retirement. Also, Real Estate Developer/ Investors live off of asset conversion.

If this is your guideline, consider how it is worded and what guidance is provided to allow for the lending professional to apply good judgment.

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Qualifying Income

How could I use potential capital gains from sale of stock, even though the prospective borrower has not sold any in the last three years?

Some lenders allow use of potential sale of stock:

- 1) Obtain stock broker's statement to determine portfolio amount
- 2) Consider reducing the portfolio by some % (20, perhaps) to be conservative
- 3) Annuitize the remainder over 30 years, or 20 years if already retired.

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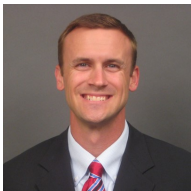
Q&A, Contact Information.



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