RD AN No. 3950 (1980-D)
March 3, 2004

TO: All State Directors
Rural Development

ATTENTION: Rural Housing Program Directors, Guaranteed Rural Housing Specialists, Rural Development Managers, and Community Development Managers

FROM: Arthur A. Garcia ***(Signed by Arthur A. Garcia)***
Administrator
Rural Housing Service

SUBJECT: Single Family Housing Guaranteed Loan Program (SFHGLP)
Determining Repayment Income for Self-Employed Applicants

PURPOSE/INTENDED OUTCOME:

The purpose of this Administrative Notice (AN) is to provide guidance on how to properly analyze a self-employed applicant's loan application for repayment ability. This AN addresses the following topics:

- What documentation is generally required for self-employed applicants?
- What method should the lender's underwriter use when analyzing the applicant's tax returns?
- How should the underwriter treat business-related debts that are paid with business funds, rather than personal income?

Following these guidelines will ensure processing uniformity and reduce the possibility of underwriting errors.

COMPARISON WITH PREVIOUS AN:

This AN replaces RD AN No. 3833 (1980-D) dated March 19, 2003.

EXPIRATION DATE:
March 31, 2005

FILING INSTRUCTIONS:
Preceding RD Instruction 1980-D

BACKGROUND:

Underwriting the self-employed loan applicant has always been especially challenging. Not only must the underwriter make sense out of complex tax returns, profit and loss statements, balance sheets and other related documentation, the underwriter must be able to use sound reasoning and judgment when deciding which rules to apply and when.

The mortgage industry has had varying success in establishing only one way to underwrite a self-employed loan applicant. The underwriter must apply specific rules to the loan application depending on investor, insurer, or guarantor.

The SFHGLP requires the Lender to determine:

- The self-employed applicant's adequate and dependable income. [RD Instruction 1980-D, Section 1980.345(b)] This income figure is used to determine the applicant's *qualification* to repay the requested loan.

- The self-employed applicant's annual income and adjusted annual income. (RD Instruction 1980-D, Sections 1980.347, 1980.345(a) and 1980.348) These income figures are used in the determination of an applicant's *eligibility* for the RHS loan guarantee.

SFHGLP regulations recognize that an applicant's *qualifying* income may be different than the applicant's *eligibility* income. [RD Instruction 1980-D, Section 1980.345(c)(2)(i)] This distinction is important to remember when determining how to apply the different rules.

The annual income determination requirements in RD Instruction 1980-D, Section 1980.347(d)(2) were designed to help ensure that the program benefits go to eligible households. Consistent application of these requirements is important to ensure fairness to all self-employed applicants.

The adequate and dependable repayment income requirements in RD Instruction 1980-D, Section 1980.345(b) and (c) were designed to help ensure that borrowers will be able to make the loan payments and stay in their home. Consistent application of these requirements is important to ensure that all qualified self-employed borrowers are approved for a Guaranteed Rural Housing (GRH) loan.

DOCUMENTATION:

To permit required verification of income under RD Instruction 1980-D, Section 1980.353, self-employed applicants should submit copies of their signed individual Federal tax returns that were filed with the IRS for the most recent two years. As an alternative, the lender may obtain IRS-issued transcripts of the borrower's tax returns, as long as the transcripts include the information from all of the applicable schedules.

The tax return documentation should be complete and include all appropriate schedules. The type of self-employment (e.g., sole proprietorship, partnership, or corporation), typically will determine which schedules are appropriate. Examples of tax return documentation include Form 1040 (Individual Income Tax Return), Schedule C (Profit or Loss from Business, Sole Proprietorship), Schedule F (Profit or Loss from Farming), Schedule D (Capital Gains and Losses), Schedule SE (Self-Employment Tax) and Schedule J (Farm Income Averaging). Other tax forms include Form 1065 (Partnership), Form 1120S (S Corporation), and Form 1120 (Corporation).

The self-employed applicant also should submit current documentation of the business's income and expenses, including any applicable Federal tax returns that were filed with the IRS for the most recent two years as well as year-to-date profit and loss and balance statements. Depending on the facts of the individual application, the lender may require more documentation in order to determine the self-employed applicant's income.

In all cases, the lender must obtain sufficient documentation to support its determination regarding the viability of the business and the self-employed applicant's income. Only after the lender receives adequate documentation may the self-employed applicant's qualifying income be accurately calculated.

For quality assurance purposes, the lender should require the self-employed applicant to sign IRS Form 4506, "*Request for Copy or Transcript of Tax Form,*" or IRS Form 8821, "*Tax Information Authorization,*" at the time of application and send the form to the IRS during the processing of the loan application. (The lender does not have to receive the information back from the IRS before closing the loan.)

<u>UNDERWRITING METHODS AND FORMS</u>:

We encourage the lender's underwriter to use:

- Fannie Mae Form 1084, "*Cash Flow Analysis*";
  --and--
- Fannie Mae Form 1088, "*Comparative Income Analysis*" to document a trend analysis for the borrower's business.

The lender may use the Fannie Mae forms or any documentation that provides the same information. Regardless of the analysis method used, and the documentation prepared by the lender, the loan file must contain clear and sufficient support for the underwriter's decisions regarding the viability of the business and loan approval.

<u>HOW TO TREAT BUSINESS DEBTS</u>:

Traditionally, the primary business structure that many of our self-employed applicants engage in is a sole proprietorship (a business, farm, or profession). The success of this type of endeavor depends largely on the individual owner, and business income or loss is reported in the individual owner's personal tax return.

Also, although the individual owner has personal liability for all debts of the business in a sole proprietorship, business-related debts are often paid with business funds, rather than personal income.

The lender may use the following guidance regarding calculation of the sole proprietor's repayment income when completing the calculations required by RD Instruction 1980-D, Sections 1980.345(b) and (c).

1. <u>Add</u> the following allowable IRS deductions to net profit (item #31 on Schedule C or item #36 on Schedule F):

- Depletion (item #12 on Schedule C)
- Depreciation (item #13 on Schedule C or item #16 on Schedule F)
- Interest (item #16a. and b. on Schedule C or item #23a. and b. on Schedule F)

2. <u>Subtract</u> all debt payments (principal and interest) that the operating expense documentation clearly shows as being paid with business funds (expressed in annual terms, not monthly) to determine the sole proprietor's repayment income.

Net profit + Depletion + Depreciation + Interest – Annual business-related debts = Repayment Income

The IRS requires that costs associated with going into business, business assets (i.e. land, buildings, vehicles, etc.), and improvements be capitalized. Although a deduction for capital expenses generally is not permitted, the IRS may allow deductions for the related expenses through depletion/depreciation and for interest paid on business-related debts. The amounts deducted, however, do not necessarily equal the payments due on business-related debts. We believe the above equation will properly address this issue and permit more qualified rural residents to be approved for a SFHGLP loan.

Business-related debts treated in this manner will not be included in the debt-to-income ratios since they were accounted for in the calculation of repayment income.

SUMMARY:

Please note that the methodology described in this AN applies only to the self-employed applicant's *qualifying* or *repayment* income. Underwriters must continue to follow the provisions of RD Instruction 1980-D, Section 1980.347(d)(2) regarding capital expenditures and straight-line depreciation when determining annual income for *eligibility* purposes.

State Offices having questions regarding this AN should contact Robert Keyes or Joaquin Tremols at (202) 720-1452 or Robert.Keyes@usda.gov or Joaquin.Tremols@usda.gov.