

# K-1 Income – Fannie Mae Loans

February 8, 2016



# Important Note!

The accompanying materials have been amended from the original presentation specific to the measurement for liquidity. Slides 8-10 have been changed. The following formulas can be used to measure liquidity:

## **Current Ratio:**

Current Assets (this is the sum of lines 1, 2 & 3 on Schedule L of the 1065 or 1120S) divided by Current Liabilities (this is the sum of lines 16, 17 & 18 on Schedule L of the 1065 or 1120S).

Acceptable ratio is 2:1 or higher.

## **Quick Ratio:**

Quick Assets (sum of lines 1 & 2) divided by Current Liabilities (sum of lines 16, 17 & 18).

Acceptable ratio is 1:1 or higher.

*The recorded presentation does not reflect the changes that were made on slides 8-10.*

FAQs are added at the end of the presentation.

- FNMA Self Employed changes effective for applications on or after 2/1/16
- Impacts borrowers receiving K-1's if the K-1 income must be used to qualify.
- There is no change to the treatment of K-1 losses.
- Freddie Mac has not changed their guidance.

# Does the Borrower receive a distribution?

The K1 form – Box 19A or Box 16D will indicate if the borrower is receiving a distribution from the Business.

**Schedule K-1 (Form 1065) 2014**  
Department of the Treasury Internal Revenue Service

**Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items**

1 Ordinary business income (loss) 15 Credits  
2 Net rental real estate income (loss) 16 Foreign transactions  
3 Other net rental income (loss) 17 Dividends  
4 Guaranteed payments 18 Interest income  
5 Other income 19a Ordinary dividends  
6a Qualified dividends 19b Dividends  
7 Dispositions 19c Items affecting shareholder basis

**Part I Information About the Partnership**

A Partnership's employer identification number  
B Partnership's name, address, city, state, and ZIP code  
C EIN Center where partnership filed return  
D  Check if this is a publicly traded partnership (PTP)  
E Partner's identifying number  
F Partner's name, address, city, state, and ZIP code  
G  
H  
I  
J Beginning Ending  
Part II  
K Partner's share of liabilities at year end  
L Partner's capital account analysis  
M  Yes  No

**Distributions Box 19A**

**19 Distributions**

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**Schedule K-1 (Form 1120S) 2014**  
Department of the Treasury Internal Revenue Service

**Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items**

1 Ordinary business income (loss) 13 Credits  
2 Net rental real estate income (loss) 14 Foreign transactions  
3 Other net rental income (loss) 4 Interest income  
5a Ordinary dividends 5b Qualified dividends 5c Dividends  
6 Dispositions 7 Dispositions 8 Other information

**Part I Information About the Corporation**

A Corporation's employer identification number  
B Corporation's name, address, city, state, and ZIP code  
C EIN Center where corporation filed return  
D Shareholder's identifying number  
E Shareholder's name, address, city, state, and ZIP code  
F Shareholder's percentage of stock ownership for tax year

**Part II Information About the Shareholder**

9  
10  
11 Section 179 deduction 12 Other deductions 13 Other information  
14  
15  
16 Items affecting shareholder basis  
17 Other information

**Distributions Box 16D**

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# Compare Distribution Amount to Ordinary Income in Box 1

If the Ordinary Income (Box 1) is the same as the Distribution amount then the Ordinary income can be used.

- No further steps are necessary to prove access to funds or business liquidity.

Schedule K-1 (Form 1065) for 2014. The form is titled "Partner's Share of Current Year Income, Deductions, Credits, and Other Items". It is divided into Part I (Information About the Partnership) and Part III (Partner's Share of Current Year Income, Deductions, Credits, and Other Items). A red arrow points from Box 1 of Part I to Box 1 of Part III.

Box	Description
1	Ordinary business income (loss)
2	Net rental real estate income (loss)
3	Other net rental income (loss)
4	Guaranteed payments
5	Interest income
6	Foreign transactions
7	Unrecaptured section 1252 gain
8	Net section 1231 gain (loss)
9	Other income (loss)
10	Section 179 deduction
11	Other deductions
12	Other information
13	Credits
14	Tax-exempt income and nondeductible expenses
15	Distributions
16	Items affecting distributable basis

Schedule K-1 (Form 1120S) for 2014. The form is titled "Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items". It is divided into Part I (Information About the Corporation) and Part III (Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items). A purple arrow points from Box 1 of Part I to Box 1 of Part III.

Box	Description
1	Ordinary business income (loss)
2	Net rental real estate income (loss)
3	Other net rental income (loss)
4	Interest income
5	Foreign transactions
6	Unrecaptured section 1252 gain
7	Net section 1231 gain (loss)
8	Other income (loss)
9	Section 179 deduction
10	Other deductions
11	Credits
12	Tax-exempt income and nondeductible expenses
13	Distributions
14	Items affecting distributable basis

## Compare Distribution Amount to Ordinary Income in Box 1

If the distribution amount is less than the ordinary income, or no distribution amount is listed on the K1, we must confirm the following before including the ordinary income in our cash flow.

- Borrower can document access to the income.
  - We will need a copy of the Corporate Resolution or Partnership Agreement.
  - If they are 100% owner, no documentation is needed.
  
- The Business has adequate liquidity to support withdrawal of earnings.

# How to determine if 100% owner?

## Schedule K-1 IRS Form 1065

J Partner's share of profit, loss, and capital (see instructions):				
	Beginning		Ending	
Profit		%		%
Loss		%		%
Capital		%	<input type="text"/>	%

## Schedule K-1 IRS Form 1120S

F	Shareholder's percentage of stock ownership for tax year . . . . .	_____ %
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## Example K-1

What step(s) do we need to take with this example?

Distribution amount is less than ordinary income.

Document access to funds? No, he is 100% owner.

Now we need to determine liquidity.

Schedule K-1 (Form 1120S)		2014		Final K-1 <input type="checkbox"/> Amended K-1 <input type="checkbox"/>		OMB No. 1545-0123	
Department of the Treasury Internal Revenue Service				For calendar year 2014, or tax year beginning <u>MAY 1, 2014</u> ending <u>DECEMBER 31, 2014</u>			
<b>Shareholder's Share of Income, Deductions, Credits, etc.</b> ▶ See separate instructions.				<b>Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items</b>			
<b>Part I Information About the Corporation</b>				1	Ordinary business income (loss)	13	Credits
A Corporation's employer identification number					247,252.		
B Corporation's name, address, city, state, and ZIP code				2	Net rental real estate inc (loss)		
C IRS Center where corporation filed return <b>E-FILE</b>				3	Other net rental income (loss)		
<b>Part II Information About the Shareholder</b>				4	Interest income		
D Shareholder's identifying number				5a	Ordinary dividends	31.	
E Shareholder's name, address, city, state and ZIP code				5b	Qualified dividends	14	Foreign transactions
F Shareholder's percentage of stock ownership for tax year				6	Royalties		
				7	Net short-term capital gain (loss)		
				8a	Net long-term capital gain (loss)		
				8b	Collectibles (28%) gain (loss)		
				8c	Unrecaptured sec 1250 gain		
				9	Net section 1231 gain (loss)		
				10	Other income (loss)	15	Alternative min tax (AMT) items
				11	Section 179 deduction	16	Items affecting shareholder basis
						C*	9,490.
				12	Other deductions	D	203,758.
						17	Other information
						A	31.

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## Business Liquidity

Here we are determining if the business has adequate liquidity to support the withdrawal of earnings by using one of the two ratios below.

- ✓ The resulting ratio must be a minimum of:
  - ✓ 2:1 for the Current ratio
  - ✓ 1:1 for the Quick ratio

### Current Liquidity Ratio

Current Assets / Current Liabilities

(sum of lines 1, 2 & 3) / (sum of lines 16, 17, & 18) – from schedule L

### Quick Ratio for Liquidity

Quick Assets / Current Liabilities

(sum of lines 1 & 2) / (sum of lines 16, 17, & 18) – from schedule L

## Business Liquidity

The ratio will be calculated using the numbers off of Schedule L from the tax returns.

- ❑ If the return does not include figures on Schedule L, then we will need a copy of the most recent balance sheet for the Business.

On Schedule L, we are looking at:

Lines 1-3, column D for Current Assets

Lines 16-18, column D for Current Liabilities

<b>Schedule L</b>		<b>Balance Sheets per Books</b>		<b>Beginning of tax year</b>		<b>End of tax year</b>	
		<b>Assets</b>		<b>(a)</b>	<b>(b)</b>	<b>(c)</b>	<b>(d)</b>
<b>1</b>	Cash . . . . .						
<b>2a</b>	Trade notes and accounts receivable . . . . .						
<b>b</b>	Less allowance for bad debts . . . . .						
<b>3</b>	Inventories . . . . .						
<b>4</b>	U.S. government obligations . . . . .						
<b>5</b>	Tax-exempt securities . . . . .						
<b>6</b>	Other current assets (attach statement) . . . . .						
<b>7a</b>	Loans to partners (or persons related to partners)						
<b>b</b>	Mortgage and real estate loans . . . . .						
<b>8</b>	Other investments (attach statement) . . . . .						
<b>9a</b>	Buildings and other depreciable assets . . . . .						
<b>b</b>	Less accumulated depreciation . . . . .						
<b>10a</b>	Depletable assets . . . . .						

# Example - Business Liquidity

Current Assets / Current Liabilities

\$61,350 / \$30,675

2:1 ratio

Schedule L	Balance Sheets per Books	Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
<b>Assets</b>					
1	Cash .....		18,544.		61,350.
2 a	Trade notes and accounts receivable .....				
b	Less allowance for bad debts .....				
3	Inventories .....				
4	U.S. government obligations .....				
5	Tax-exempt securities .....				
6	Other current assets (att. stmt.) .....				
7	Loans to shareholders .....		26,843.		26,883.
8	Mortgage and real estate loans .....				
9	Other investments (att. stmt.) .....				
10 a	Buildings and other depreciable assets .....	26,042.		26,042.	
b	Less accumulated depreciation .....	2,222.	23,820.	2,222.	23,820.
11 a	Depletable assets .....				
b	Less accumulated depletion .....				
12	Land (net of any amortization) .....		23,084.		23,084.
13 a	Intangible assets (amortizable only) .....				
b	Less accumulated amortization .....				
14	Other assets (att. stmt.) .....				
15	<b>Total assets</b> .....		92,291.		135,137.
<b>Liabilities and Shareholders' Equity</b>					
16	Accounts payable .....				30,675.
17	Mortgages, notes, bonds payable in less than 1 year .....				
18	Other current liabilities (att. stmt.) .....				
19	Loans from shareholders .....				
20	Mortgages, notes, bonds payable in 1 year or more .....				
21	Other liabilities (att. stmt.) .....				
22	Capital stock .....				
23	Additional paid-in capital .....				
24	Retained earnings .....	STATEMENT 5	92,291.		104,462.
25	Adjustments to shareholders' equity (att. stmt.) .....				
26	Less cost of treasury stock .....				
27	<b>Total liabilities and shareholders' equity</b> .....		92,291.		135,137.

## Use his income?

*Distribution amount is less than ordinary income.*

*We don't need to document access to funds since he is 100% owner.*

*We've determined liquidity meets our requirement of 2:1*



*Now we can use his ordinary income for qualifying.*

Schedule K-1 (Form 1120S) **2014** Final K-1 Amended K-1 OMB No. 1545-0123

Department of the Treasury Internal Revenue Service For calendar year 2014, or tax year beginning MAY 1, 2014 ending DECEMBER 31, 2014

**Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items**

1	Ordinary business income (loss)		247,252.
2	Net rental real estate inc./loss		
3	Other net rental income (loss)		
4	Interest income		31.
5a	Ordinary dividends		
5b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured sec 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative min tax (AMT) items
11	Section 179 deduction	16	Items affecting shareholder basis
		C*	9,490.
12	Other deductions	D	203,758.
		17	Other information
		A	31.

**Part I Information About the Corporation**

A Corporation's employer identification number [REDACTED]

B Corporation's name, address, city, state, and ZIP code [REDACTED]

C IRS Center where corporation filed return  
**E-FILE**

**Part II Information About the Shareholder**

D Shareholder's identifying number [REDACTED]

E Shareholder's name, address, city, state and ZIP code [REDACTED]

F Shareholder's percentage of stock ownership for tax year ..... 100.000000%

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# Guaranteed Payments

We can add Guaranteed Payments to the income.

## Form 1084 Part 7, 8

IRS Form 1065 - Partnership Income

7. Schedule K-1 Form 1065 - Partner's Share of Income

	Year _____	Year _____
a. Ordinary Income (Loss)	(+/-) _____	(+/-) _____
b. Net Rental Real Estate; Other Net Income (Loss)	(+/-) _____	(+/-) _____
c. Guaranteed Payments to Partner	(+) _____	(+) _____

8. Form 1065 - Adjustments to Business Cash Flow

	(+/-) _____	(+/-) _____
a. Ordinary (Income) Loss from Other Partnerships	(+/-) _____	(+/-) _____
b. Nonrecurring Other (Income) Loss	(+/-) _____	(+/-) _____
c. Depreciation	(+) _____	(+) _____
d. Depletion	(+) _____	(+) _____
e. Amortization/Casualty Loss	(+) _____	(+) _____
f. Mortgages or Notes Payable in Less than 1 Year	(-) _____	(-) _____
g. Non-deductible Travel and Entertainment Expenses	(-) _____	(-) _____
h. Subtotal	_____	_____
i. Total Form 1065 (Subtotal multiplied by % of ownership)	_____	_____

## Additional Items

- Business assets will not be used to support liquidity. We need to utilize Schedule L or the most recent balance sheet.
- Verification of additional cash is not required if liquidity ratio is at least 1:1.
- If the income is rolled to Schedule C, we do not have to prove business liquidity since the income has been received by the borrower.



## FAQs

**If borrower has no distributions, only ordinary income and is 100% owner are we still OK to just use the income or do they have to have distributions?**

In this scenario, because the borrower does not have distributions we would need to document liquidity. However, since he or she is 100% owner, we would not have to document access to the funds. Utilize the current or quick liquidity ratio methods to determine liquidity. See slide #8 for examples of how to calculate.

**How do we determine liquidity?**

In order to determine the liquidity of the business we would use one of the following two ratios:

Current Liquidity Ratio  
Current Assets / Current Liabilities  
Resulting Ratio must be a minimum of 2:1

Quick Ratio for Liquidity  
Quick Assets/ Current Liabilities  
Resulting ratio must be a minimum of 1:1

**What happens if the liquidity ratio is less than 1:1?**

If the ratio is less than 1:1, we would not be able to use the ordinary income to qualify the borrower.

**If distribution income on the K1 is lower than ordinary income, can we just qualify them on the distribution amount?**

Yes.



## FAQs

### **What do we do if the borrower carries his income over from his K-1 onto Schedule C?**

If the borrower's income from the K-1 flows through another business entity onto a Schedule C, we would use the Schedule C to calculate the qualifying income. You would not have to follow any of the steps mentioned in this presentation.

### **I've never had to review a corporate resolution before, is it pretty straight forward to see who has access to funds? What am I looking for in that document?**

For this training's purpose, you are looking to identify the borrower has access to business funds. There is a section in a corporate resolution that identifies who has access, here is an example:

THAT [REDACTED] be and are/is hereby authorized on behalf of the Company to draw, sign, accept, endorse, or make checks, bills of exchange, warrants issued in payment of dividends or interest, and other orders for the payment of money (whether the account is overdrawn by the payment thereof in credit), and to withdraw any or all securities or other property in the hands of the Bank including any box or boxes, sealed envelopes or packets, and their contents, and to arrange for credit facilities for the Company (including letters of credit and forward exchange contracts), and to sign in favor of the Bank guarantees of the obligations of third parties, and in connection with any such credit facilities or guarantees to give security to the Bank on all or any of the property, real or personal, present or future of the Company.

### **Has FNMA updated their Income Analysis form with these new guidelines?**

Yes, the updates were released in December, and have been posted on our [intranet](#) since then for review. The implementation of the new guidance was not mandatory until February 1<sup>st</sup>, 2016.

[Fannie Mae Form 1084](#)

### **If the income on K1 is shown on line 2 net rental income is the distribution required?**

Yes, the calculation is the same.

### **Do we have to worry about distributions if the borrower has less than 25% ownership?**

If you need the income to qualify, yes. The process is the same as for greater than 25% ownership. With the exception of nominal payments for guaranteed payments to partner <2yrs documented income can be acceptable for certain professional services (i.e. law firm or medical practice).

## FAQs

**If Schedule L is not completed and the borrower claims the income on Schedule C, then a balance sheet is not required?**

Correct, then you would utilize the Schedule C to qualify the borrower and the K-1 calculations would be unnecessary.

**Do these requirements apply to Freddie Mac as well?**

No, at this time Freddie Mac has not implemented these requirements. The guidelines remain unchanged.

**So Freddie Mac does not require liquidity information for a distribution?**

Correct, at this time documenting business liquidity and/or borrower access to funds is not required by Freddie Mac.

**In order to utilize the guaranteed payments do you want to go through the entire calculation process?**

No, guaranteed payments to partners are always acceptable as qualifying income. You will use a two year average, unless DU provides the reduced documentation option for 1 year.

**If the income from the K1's gets transferred to the 1040's, why is Fannie Mae requiring this exercise?"**

According to FNMA, analyzing business cash flow aligns self-employment income eligibility with their standard income policy that does not measure eligibility by the taxable nature of the income, but instead confirms that a borrower receives, or in the case of business income, has the right and ability to draw the income being used to qualify.

**If non borrowing spouse is the other percentage owner what do you need to prove access?**

We would need the partnership agreement, even if the balance of the business ownership resides with the non-borrowing spouse.