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## ANALYSIS OF INCOME AND FORM 1040

Income received is listed on lines 7 through 21 of the 20xz PTR Form 1040. The following key questions are on income:

- Was it really cash received?
- What was the source?
- Will it be recurring?
- What amount is noncash income or expense (such as depreciation)?
- What amount is available to the individual?

**NOTE****Note about line numbers on tax forms**

The various line numbers can change from year to year, although there have been very few changes in recent years. As you work with tax returns in the future, understand that lines can shift or even be combined with other lines.

**Line 7: Wages and salaries**—This line includes wages paid by employers, including firms that may be owned by the taxpayer, but excludes sole proprietorships or partnerships. The amount reported on line 7 is net of pretax deductions, such as 401(k) contributions. Reported income can include noncash benefits, such as personal use of a company vehicle. A business banker should verify the mix and amount of income for this line, using the W-2 for verification.

In our example for 20xz, the Dezines reported total wages of \$159,588 from a combination of Designs by Dezine, Inc. (an S corporation owned by Linda) and Structured Engineering, Inc. (Ed's employer). The business tax return for Designs by Dezine showed compensation paid to Linda of \$42,700, which matches the amount reported on their PFS. Also on the PFS, Ed reported \$80,000 of income, so approximately \$37,000 came from another source. A business banker should ask for W-2s to clarify the income and sources. Some state tax return formats have separate lines for each employer, and it is not necessary to obtain W-2s.

**Line 8: Taxable interest income**—The amount on lines 8a is itemized on Schedule B. Total interest income includes taxable (line 8a) and tax-exempt (line 8b) interest earned on deposits, bonds, notes, mortgages, and accounts receivable. Compare the amounts reported on line 8 to the PFS, to ensure that the income will continue. The reported interest amount, based on current interest rates, gives a business banker an idea of the average level of deposits during the year, and should be close to the amounts reported on the PFS (or shown on your bank's deposit system, if the account is with your bank). Historical levels of cash shown on earlier PFSs and interest income shown on earlier Schedule Bs can help determine whether the deposits are expected to remain the same in the future. Anticipated changes in interest rates can also be a factor on the stability of this income. If rates are expected to fall, the interest income may decrease even if the deposits remain the same.

In our example for 20xz, the Dezines received \$2,428 in interest income from a bank account, which is listed on Schedule B and appears reasonable, if interest rates for deposits in 20xz were about 5 percent, because they listed \$45,000 of cash on their PFS.

**Line 9: Dividend income**—The amount of dividend income also is itemized on Schedule B. A distinction should be made between dividends, distributions and capital gains. Dividends generally are amounts paid out of the profits or earnings of a corporation to its investors. Dividends paid to owners of C corporations are taxable income to the recipient, in most cases. However, dividends or distributions paid to owners of partnerships, LLCs, and S corporations usually are not taxable income to the recipient. Capital gains, but not dividends and distributions, arise from the sale of assets, and are reported on schedule D.

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Ordinary dividends (line 9a) are the most common type of distribution from a corporation. They are paid out of the earnings and profits of the corporation. Ordinary dividends are taxable as ordinary income unless they are qualified dividends. Qualified dividends (line 9b) are a portion of ordinary dividends that meet certain requirements to be taxed at lower rates. So, total dividend income is shown on line 9a, with no need to include any amounts shown on line 9b.

Note that some dividends, particularly from banks and large companies, can be involved in a dividend reinvestment program (DRIP) where the proceeds are used to purchase additional shares of common stock of the bank or large company, and the taxpayer does not actually receive cash for the dividends. The dividend income, however, is still reported on Schedule B, even if the taxpayer did not receive the cash.

In our example for 20xz, the Dezines own a mutual fund account that paid them \$8 in ordinary dividends.

Line 10: State income tax refunds—Verify the amount reported on line 10 with the previous year's state income tax return. Generally, amounts reported on line 10 are not recurring and are not considered as cash available to service future debt. In many cases they are small and not material to a cash flow analysis. In our 20xz example, the Dezines did not list state income tax refunds.

Line 11: Alimony—Verify the terms of the alimony payments with the divorce decree. If the payment is to be discontinued in the near future, the business banker needs to take that into account when assessing the ability to repay long-term loans. Review the divorce decree to determine if there are any escalation clauses in the payments.

Line 12: Business income—Schedule C details all income and expenses from sole proprietorships. In most cases, business bankers take net profit (or loss) from line 31 and add back depletion from line 12, depreciation expense from line 13 (both noncash items) and interest expense from line 16 (to avoid double counting with debt service). Depreciation also can be included in cost of goods sold, which is detailed on page 2 of Schedule C. Specifically, look for line 39 "other costs" and supporting information attached to the PTR or provided by the customer.

In some cases, where a business banker is providing debt to purchase an asset to replace one that has been leased, it may be necessary to adjust or add back some of the rental expense from line 20. One more adjustment involves meal and entertainment expenses. Because only 50 percent of these expenses are deductible, it is necessary for cash flow purposes to reduce reported net income (or loss) by the other 50 percent that was expended and not deducted.

In our example for 20xz, Linda Dezine shows ownership of a teaching and consulting business that provides seminars to contractor associations and consults with other contractors on remodeling projects. The business has gross receipts of \$39,587 and net profits of \$39,518. No depletion, depreciation, interest, rental, or meals/entertainment expense is shown.

Line 13: Capital gain or (loss)—Gains and losses occur when assets are sold for more or less than their book or depreciated value. Determine from Schedule D if cash was received and whether the transactions will be a continuing source of cash flow. If they are not going to continue, the cash flow usually will not be counted when determining the ability to repay future loans. Further, if the cash proceeds, net of any debt repaid, are reinvested in another asset, the cash flow may not be counted. Access to a PFS and questions to the individual can clarify the true nature of any proceeds.

Starting in 2011, Form 8949 was implemented to list transaction details (previously listed directly on Schedule D) of the various short-term and long-term asset sales as an attachment to Schedule D. As many as three copies of this form can be used, depending on whether the taxpayer (a) received a Form 1099-B reporting the transaction reporting the cost basis of the asset sold, (b) received a Form 1099-B that did not include the cost basis, or (c) did not receive a Form 1099-B for the transaction.

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Sales of business assets and depreciable assets, such a rental real estate held personally, are reported on Form 4797, with the gain or loss shown on line 11 of Schedule D. Some gains and losses reported with form 4797 are reported directly on line 14 of Form 1040 (see below). As with Schedule D, a business banker will need to determine the cash generated from the transaction, plus determine whether such a transaction will be recurring.

In some cases, there are tax advantages for breaking a large capital gain into smaller amounts of taxable income. This is called an *installment sale*, reported on Form 6252 and also summarized on line 11 of Schedule D. Form 6252 shows the principal payments received during the year, and any interest received will be shown on Schedule B. Depending on the structure of the installments, what is usually considered a non-recurring transaction can actually generate a series of cash flows over several years that can be included in a cash flow analysis.

In our 20xz example, on Form 8949 the Dezines reported a loss on the sale of shares of a mutual fund (National Fund) of (\$1,324), but with proceeds of \$9,728. The proceeds represent the cash flow for 20xz, while an outflow of \$11,052 occurred in 20xy. We do not know if the Dezines reinvested the proceeds into another mutual fund, although they have shown dividend income from the fund and listed the fund as a holding on their PFS.

**NOTE** Tax returns can be a puzzle

In addition to the complexity of tax laws, the tax return forms and schedules often do not provide bankers all of the information needed to determine the cash flow impact of various reported income and expense items. Therefore, tax return analysis is difficult to complete from tax returns alone. It requires access to previous tax returns, current and previous personal financial statements, brokerage statements, and credit bureau reports—as well as access to the customer for questions. Especially for capital gains and losses, a banker needs information about the actual cash involved in the asset sale, whether any debt was repaid from proceeds and what was done with the net proceeds. To count the transaction as recurring, levels of similar asset holdings (such that transactions can happen again in the future) and the customer's plans are important.

Line 14: Other gains and losses—Amounts listed on line 14 are from the sale of business assets and depreciable assets reported on Form 4797, but not included on Schedule D. As with capital gains and losses discussed earlier, a business banker will need to determine the cash generated from the transaction, plus determine whether such a transaction will be recurring.

Lines 15a and 16a: IRA distributions and pensions and annuities—This is the total amount distributed to the taxpayer, with the taxable portion shown on lines 15b and 16b. If the individual is retired, distributions should be received in the future and significant portions may not be subject to taxes. The amount to be received depends on the value of retirement accounts. Verify distributions with the amount listed on the PFS for retirement assets. If the individual is not eligible for retirement, then amounts taken out early are subject to substantial penalties and taxes. Also, the amount shown on line 15a can be a rollover distribution from an IRA or other qualified retirement plan, and should not be counted as cash flow.

Line 17: Rental real estate, royalties, partnerships, estates, and trusts—This line includes several items commonly used by business bankers, including rental real estate and taxable income or loss from pass-through entities shown on Schedule E. Reported income from all of these activities is not necessarily cash. For rental real estate, amounts reported are net of depreciation and amortization (noncash expenses) that need to be added back. Any interest expense is added back to prevent double-counting with debt service.

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**NOTE****Annualizing certain income or loss items for debt coverage ratios**

Income or loss reported on several tax forms may need to be annualized or rendered on a monthly basis for only the months of operation when computing cash flow to use in a debt coverage ratio. Schedule C (sole proprietorships), Schedule E (rental real estate) and Schedule F (farms) are examples of business schedules that do not clearly indicate whether the business operated for the entire tax period. In such cases, a business banker will need to consult the customer or other resources to determine the appropriate number of months or weeks of operations in order to properly adjust the income or loss prior to developing a monthly debt-to-income (DTI) ratio or annual debt service coverage (DSC) ratio.

For partnerships, LLCs, and S corporations, use the appropriate Schedule K-1 (using tax identification numbers shown on the second page of Schedule E) to determine the actual amount of cash inflow or outflow involved:

- Schedule K-1 (Form 1065) is used by both partnerships and LLCs, because LLCs are taxed as partnerships in most situations. Box 1 will show the ordinary income or loss that appears on Schedule E. Actual cash inflow to the taxpayer will be shown in box 4 (compensation or salary labeled as guaranteed payments) and box 19 (distributions, usually with the letter code A). Any contributions from the taxpayer into the partnership or LLC will be shown in section L in the bottom left-hand corner, along with the distributions repeated. Business bankers use the net distribution (contribution) for personal cash flow
- Schedule K-1 (Form 1120S) is used by S corporations. Box 1 will show the ordinary income or loss passed through to Schedule E. Distributions do not have a dedicated box, but are a part of box 16 labeled *items affecting shareholder basis*, with amounts designated with letter code D being distributions, usually as cash. However, this K-1 does not have a section L to show any offsetting contributions by the owner into the S corporation, so a business banker should ask the customer if any contributions have been made, as well as if any distributions were made in cash, instead of other assets or property

In our 20xz example, the Dezines do not have rental real estate, so page 1 of Schedule E is blank. They reported a net loss of \$26,031 on Schedule E Part II on the second page. This is the net amount of taxable loss from Designs by Dezine, Inc., after allowable deductions. Since the related K-1 did not show any distributions, based on the information in the tax returns and forms we do not have any cash inflow or outflow to utilize in our analysis.

Line 18: Farm income (or loss)—Schedule F for farms is very similar in format and analysis as Schedule C for sole proprietorships. In most cases, business bankers take net profit (or loss) from line 34 and add back depreciation expense from line 14 (a noncash items) and interest expense from line 21 (to avoid double counting with debt service). In some cases, where a business banker is providing debt to purchase an asset to replace one that has been leased, it may be necessary to adjust or add back some of the rental expense from line 24. In considering the cash flow from farming, a business banker should assess future crop prices, crops on hand, future prices of livestock, and other variables.

Lines 19-21: Unemployment, Social Security benefits, and other income—Verify any amounts listed on these lines to determine if they would continue. Unemployment benefits, which carry a maximum payment time frame, usually are not considered a recurring source of income. Other income may not be recurring, and the source should be verified. In most cases, business bankers use line 20a for the total cash flow from Social Security benefits. In our 20xz example the Dezines reported \$8,900 of other income. Details are not available in the schedules that have been provided, and since the amount is only 5 percent of adjusted gross income, it does not appear to be material. If larger, a business banker should obtain more information.

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Line 22: Total income—Line 22 is the total of lines 7 through 21. For the Dezines, the total income listed is \$183,087. A business banker should determine how much of that income was cash received and how much income was reduced by noncash deductions for depreciation and amortization. We have been discussing some of these adjustments for cash flow purposes, and formalize them later in this course.

Lines 23-35: Adjustments to income—Usually, adjustments to income are not recurring, except for IRA and retirement plan contributions. The \$2,791 the Dezines listed on line 27 represents a credit for one-half of the self-employment tax due for the consulting/teaching business and does not affect cash flow. Line 29 is a credit for apportionment of self-employed health insurance expenses and does not affect cash flow.

Lines 37-38 Adjusted gross income (AGI)—This is an important number that affects the thresholds for a number of deductions and credits throughout a PTR. However, as we have already pointed out, for business owners this may not be an accurate indication of actual personal cash flow.

Line 40: Itemized deductions—Itemized deductions listed on Schedule A primarily are cash expenditures, with a few noncash deductions. Medical and dental expenses on line 1 rarely exceed the amount to be deducted, yet are a cash outlay. Compare the state income taxes listed on line 5 to the W-2s or the general sales tax tables. Use local county records to verify real estate taxes shown on line 6. On line 7 is the amount of state personal property taxes, often charged in conjunction with vehicle and boat registrations. Check the home interest on line 10 with the information given on the personal financial statement for the related mortgage. Discuss the contributions on lines 16 and 17 with the borrower to determine whether these commitments will continue in the future. Amounts on line 17 usually do not involve cash expenditures. Finally, line 24 lists job expenses and other deductions that usually are cash outlays.

Line 61: Total tax—The amount of taxes due is taken from one of the tax rate schedules and adjusted for credits (lines 47–53) and other taxes (lines 56–60), including self-employment tax based on earnings from a sole proprietorship and guaranteed payments (an equivalent to salary) from a partnership. A business banker should compare this amount to total tax payments on line 72. Tax payments may be withheld from salary, as indicated and verified on a W-2, or estimated taxes may have been paid during the tax year. To avoid a penalty, estimated tax payments must be fairly close to the total tax due.