

Section D. Borrower Employment and Employment Related Income

Overview

In This Section This section contains the topics listed in the table below.

| Topic | Topic Name | See Page |
|-------|--|----------|
| 1 | Stability of Income | 4-D-2 |
| 2 | Salary, Wage and Other Forms of Income | 4-D-5 |
| 3 | Borrowers Employed by a Family Owned Business | 4-D-11 |
| 4 | General Information on Self Employed Borrowers and Income Analysis | 4-D-12 |
| 5 | Income Analysis: Individual Tax Returns (IRS Form 1040) | 4-D-17 |
| 6 | Income Analysis: Corporate Tax Returns (IRS Form 1120) | 4-D-20 |
| 7 | Income Analysis: "S" Corporation Tax Returns (IRS Form 1120S) | 4-D-22 |
| 8 | Income Analysis: Partnership Tax Returns (IRS Form 1065) | 4-D-23 |

1. Stability of Income

Introduction This topic contains information on determining a borrower's income stability, including

- effective income
 - verifying employment history
 - analyzing a borrower's employment record, and
 - borrowers returning to work after extended absences.
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Change Date March 1, 2011

4155.1 4.D.1.a Effective Income Income may not be used in calculating the borrower's income ratios if it comes from any source that

- cannot be verified
 - is not stable, or
 - will not continue.
-

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1. Stability of Income, Continued

4155.1 4.D.1.b Verifying Employment History

To be eligible for a mortgage, FHA does not require a minimum length of time that a borrower must have held a position of employment. However, the lender must verify the borrower's employment for the most recent two full years, and the borrower must

- explain any gaps in employment that span one or more months, and
- indicate if he/she was in school or the military during the most recent two full years, providing evidence supporting this claim, such as
 - college transcripts, or
 - discharge papers.

Allowances can be made for seasonal employment, typical for the building trades and agriculture, if documented by the lender.

TOTAL Scorecard Accept/Approved Recommendation

If the Technology Open To Approved Lenders (TOTAL) Scorecard returns an Accept/Approve recommendation, the borrower is not required to provide an explanation for gaps in employment of six months or less, during the most recent two years.

Note: A borrower with a 25% or greater ownership interest in a business is considered self employed and will be evaluated as a self employed borrower for underwriting purposes.

References: For more information on

- seasonal employment, see HUD 4155.1 4.D.2.d and HUD 4155.1 4.D.2.e
- self employed borrowers and income analysis, see HUD 4155.1 4.D.4, and
- the TOTAL Scorecard recommendations, see the [*TOTAL Mortgage Scorecard User Guide*](#).

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1. Stability of Income, Continued

4155.1 4.D.1.c Analyzing a Borrower's Employment Record

When analyzing the probability of continued employment, the lender must examine

- the borrower's past employment record
- qualifications for the position
- previous training and education, and
- the employer's confirmation of continued employment.

The underwriter should favorably consider a borrower for a mortgage if he/she changes jobs frequently within the same line of work, but continues to advance in income or benefits. In this analysis, income stability takes precedence over job stability.

4155.1 4.D.1.d Borrowers Returning to Work After Extended Absences

A borrower's income may be considered effective and stable when recently returning to work after an extended absence if he/she

- is employed in the current job for six months or longer, and
- can document a two year work history prior to an absence from employment using
 - traditional employment verifications, and/or
 - copies of W-2 forms or pay stubs.

Note: An acceptable employment situation includes an individual who took several years off from employment to raise children, then returned to the workforce.

Important: Employment situations not meeting the criteria listed above may *only* be considered as compensating factors. Extended absence is defined as six months.

2. Salary, Wage and Other Forms of Income

| | |
|---------------------|--|
| Introduction | <p>This topic contains information on qualifying a borrower using salary, wage, and other forms of income, including</p> <ul style="list-style-type: none"> • general policy on borrower income analysis • overtime and bonus income • overtime and bonus income earning trend • qualifying part-time income • income from seasonal employment • primary employment less than 40 hour work week • commission income • commission income earned for less than one year • employer differential payments • retirement income • Social Security income, and • automobile allowances and expense account payments. |
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| Change Date | March 1, 2011 |
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| | |
|--|--|
| 4155.1 4.D.2.a General Policy on Borrower Income Analysis | <p>The lender <i>must</i> analyze the income of each borrower who will be obligated for the mortgage debt to determine whether the borrower's income level can be reasonably expected to continue through at least the first three years of the mortgage loan.</p> |
|--|--|

In most cases, a borrower's income is limited to salaries or wages. Income from other sources can be considered as effective, if properly verified and documented by the lender.

Notes:

- Effective income for a borrower planning to retire during the first three-year period *must* include the amount of
 - documented retirement benefits
 - Social Security payments, or
 - other payments expected to be received in retirement.
- Lenders *must not* ask the borrower about possible future maternity leave.

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2. Salary, Wage and Other Forms of Income, Continued

4155.1 4.D.2.b Overtime and Bonus Income

Overtime and bonus income can be used to qualify the borrower if he/she has received this income for the past two years, and it will likely continue. If the employment verification states that the overtime and bonus income is unlikely to continue, it may not be used in qualifying.

The lender must develop an average of bonus or overtime income for the past two years. Periods of overtime and bonus income less than two years may be acceptable, provided the lender can justify and document in writing the reason for using the income for qualifying purposes.

Reference: For more information on earning trends for overtime and bonus income, see HUD 4155.1 4.D.2.c.

4155.1 4.D.2.c Overtime and Bonus Income Earning Trend

The lender *must* establish and document an earnings trend for overtime and bonus income. If either type of income shows a continual decline, the lender *must* document in writing a sound rationalization for including the income when qualifying the borrower.

A period of more than two years must be used in calculating the average overtime and bonus income if the income varies significantly from year to year.

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2. Salary, Wage and Other Forms of Income, Continued

4155.1 4.D.2.d Qualifying Part-Time Income

Part-time and seasonal income can be used to qualify the borrower if the lender documents that the borrower has worked the part-time job uninterrupted for the past two years, and plans to continue. Many low and moderate income families rely on part-time and seasonal income for day to day needs, and lenders should not restrict consideration of such income when qualifying these borrowers.

Part-time income received for less than two years may be included as effective income, provided that the lender justifies and documents that the income is likely to continue.

Part-time income not meeting the qualifying requirements may be considered as a compensating factor only.

Note: For qualifying purposes, “part-time” income refers to employment taken to supplement the borrower’s income from regular employment; part-time employment is not a primary job and it is worked less than 40 hours.

Reference: For more information on seasonal income, see HUD 4155.1 4.D.2.e.

4155.1 4.D.2.e Income From Seasonal Employment

Seasonal income is considered uninterrupted, and may be used to qualify the borrower, if the lender documents that the borrower

- has worked the same job for the past two years, and
- expects to be rehired the next season.

Seasonal employment includes

- umpiring baseball games in the summer, or
 - working at a department store during the holiday shopping season.
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2. Salary, Wage and Other Forms of Income, Continued

4155.1 4.D.2.f Primary Employment Less Than 40 Hour Work Week

When a borrower's primary employment is less than a typical 40-hour work week, the lender should evaluate the stability of that income as regular, on-going primary employment.

Example: A registered nurse may have worked 24 hours per week for the last year. Although this job is less than the 40-hour work week, it is the borrower's primary employment, and should be considered effective income.

4155.1 4.D.2.g Commission Income

Commission income *must* be averaged over the previous two years. To qualify with commission income, the borrower must provide

- copies of signed tax returns for the last two years, and
- the most recent pay stub.

Commission income showing a decrease from one year to the next requires significant compensating factors before a borrower can be approved for the loan.

A borrower whose commission income was received for more than one year, but less than two years may be considered favorably if the underwriter can

- document the likelihood that the income will continue, and
- soundly rationalize accepting the commission income.

Notes:

- Unreimbursed business expenses must be subtracted from gross income.
- A commissioned borrower is one who receives more than 25% of his/her annual income from commissions.
- A tax transcript obtained directly from the Internal Revenue Service (IRS) may be used in lieu of signed tax returns, and the cost of the transcript may be charged to the borrower.

Reference: For information on commission income received less than one year, see HUD 4155.1 4.D.2.h.

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2. Salary, Wage and Other Forms of Income, Continued

4155.1 4.D.2.h Commission Income Earned for Less Than One Year

Commission income earned for less than one year is *not* considered effective income. Exceptions may be made for situations in which the borrower's compensation was changed from salary to commission within a similar position with the same employer.

A borrower may also qualify when the portion of earnings *not* attributed to commissions would be sufficient to qualify the borrower for the mortgage.

4155.1 4.D.2.i Employer Differential Payments

If the employer subsidizes a borrower's mortgage payment through direct payments, the amount

- is considered gross income, and
 - cannot be used to offset the mortgage payment directly, even if the employer pays the servicing lender directly.
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4155.1 4.D.2.j Retirement Income

Retirement income must be verified from the former employer, or from Federal tax returns. If any retirement income, such as employer pensions or 401(k) distributions, will cease within the first full three years of the mortgage loan, the income may *only* be considered as a compensating factor.

4155.1 4.D.2.k Social Security Income

Social Security income must be verified by the Social Security Administration (SSA) or from Federal tax returns. If any benefits expire within the first full three years of the loan, the income may *only* be considered as a compensating factor.

Notes:

- The lender must obtain a complete copy of the current awards letter.
- Not all Social Security income is for retirement-aged recipients; therefore, documented continuation is required.
- Some portion of Social Security income may be "grossed-up" if deemed nontaxable by the IRS.

Reference: For information on grossing-up income, see HUD 4155.1.4.E.5.b.

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2. Salary, Wage and Other Forms of Income, Continued

4155.1 4.D.2.1 Automobile Allowances and Expense Account Payments

Only the amount by which the borrower's automobile allowance or expense account payments *exceed* actual expenditures may be considered income.

To establish the amount to add to gross income, the borrower must provide

- [IRS Form 2106](#), *Employee Business Expenses*, for the previous two years, and
- employer verification that the payments will continue.

If the borrower uses the standard per-mile rate in calculating automobile expenses, as opposed to the actual cost method, the portion that the IRS considers depreciation may be added back to income.

Expenses that must be treated as recurring debt include

- the borrower's monthly car payment, and
 - any loss resulting from the calculation of the difference between the actual expenditures and the expense account allowance.
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3. Borrowers Employed by a Family Owned Business

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**4155.1 4.D.3.a
Income
Documentation
for Borrower
Employed by
Family-Owned
Business** In addition to normal employment verification, a borrower employed by a family-owned business is required to provide evidence that he/she is not an owner of the business, which may include

- copies of signed personal tax returns, or
- a signed copy of the corporate tax return showing ownership percentage.

Note: A tax transcript obtained directly from the [Internal Revenue Service](#) (IRS) may be used in lieu of signed tax returns, and the cost of the transcript may be charged to the borrower.

4. General Information on Self Employed Borrowers and Income Analysis

Introduction This topic contains general information on self employed borrowers and analysis of the self-employed borrower's income, including

- a definition of *self employed*
- types of business structures
- minimum length of self employment
- general documentation requirements for self-employed borrowers
- establishing a self employed borrower's earnings trend
- TOTAL Scorecard Accept/Refer requirements for self employed borrowers, and
- analyzing the business's financial strength.

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**4155.1 4.D.4.a
Definition: Self
Employed
Borrower** A borrower with a 25% or greater ownership interest in a business is considered *self employed* for FHA loan underwriting purposes.

**4155.1 4.D.4.b
Types of
Business
Structures** There are four basic types of business structures. They include

- sole proprietorships
- corporations
- limited liability or "S" corporations, and
- partnerships.

References: For more information on analyzing income for

- sole proprietorships, see HUD 4155.1 4.D.5
 - corporations, see HUD 4155.1 4.D.6
 - "S" corporations, see HUD 4155.1 4.D.7, and
 - partnerships, see HUD 4155.1 4.D.8.
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4. General Information on Self Employed Borrowers and Income Analysis, Continued

**4155.1 4.D.4.c
Minimum
Length of Self
Employment**

Income from self employment is considered stable and effective, if the borrower has been self employed for two or more years.

Due to the high probability of failure during the first few years of a business, the requirements described in the table below are necessary for borrowers who have been self employed for less than two years.

| If the period of self employment is ... | Then ... |
|---|--|
| between one and two years | <p>to be eligible for a mortgage loan, the individual must have at least two years of documented previous successful employment in the line of work in which he/she is self employed, or in a related occupation.</p> <p><i>Note:</i> A combination of one year of employment and formal education or training in the line of work in which the individual is self employed or in a related occupation is also acceptable.</p> |
| less than one year | the income from the borrower may not be considered effective income. |

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4. General Information on Self Employed Borrowers and Income Analysis, Continued

4155.1 4.D.4.d General Documentation Requirements for Self Employed Borrowers

Self employed borrowers must provide

- signed, dated individual tax returns, with all applicable tax schedules for the most recent two years
- for a corporation, “S” corporation, or partnership, signed copies of Federal business income tax returns for the last two years, with all applicable tax schedules
- a year-to-date profit and loss (P&L) statement and balance sheet, and
- a business credit report for corporations and “S” corporations.

TOTAL Scorecard Accept/Approve Recommendation

If the Technology Open To Approved Lenders (TOTAL) Scorecard returns an Accept/Approve recommendation, the borrower is not required to provide business tax returns if ***all*** of the following conditions are met:

- individual Federal income tax returns show increasing self employed income over the past two years
- funds to close are not coming from business accounts, and
- the proposed FHA-insured mortgage is not a cash out refinance.

Note: A business credit report for a corporation or “S” corporation is *not* required if the loan receives a TOTAL Scorecard Accept/Approve recommendation.

References: For additional information on

- TOTAL Scorecard recommendations for corporations or “S” corporations, see the [*TOTAL Mortgage Scorecard User Guide*](#), and
- TOTAL Scorecard requirements for P&L and balance sheet, see HUD 4155.1 4.D.4.f.

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4. General Information on Self Employed Borrowers and Income Analysis, Continued

4155.1 4.D.4.e Establishing a Self Employed Borrower's Earnings Trend

When qualifying a self employed borrower for a mortgage loan, the lender must establish the borrower's earnings trend from the previous two years using the borrower's tax returns.

If a borrower

- provides quarterly tax returns, the income analysis may include income through the period covered by the tax filings, or
- is *not* subject to quarterly tax returns, or does not file them, then the income shown on the P&L statement may be included in the analysis, provided the income stream based on the P&L is consistent with the previous years' earnings.

If the P&L statements submitted for the current year show an income stream considerably *greater* than what is supported by the previous year's tax returns, the lender must base the income analysis solely on the income verified through the tax returns.

If the borrower's earnings trend for the previous two years is *downward* and the most recent tax return or P&L is *less than the prior year's tax return*, the borrower's most recent year's tax return or P&L must be used to calculate his/her income.

Reference: For additional information on the TOTAL Scorecard requirements for P&L and balance sheet, see HUD 4155.1 4.D.4.f.

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4. General Information on Self Employed Borrowers and Income Analysis, Continued

4155.1 4.D.4.f TOTAL Scorecard Accept/Refer Requirements for Self Employed Borrowers

For the self employed borrower, the TOTAL Scorecard Accept/Approve recommendation does not require a P&L and balance sheet be provided, unless the income used to qualify the borrower exceeds that of the two-year average, based on tax returns. In such a case, either an audited P&L statement, or signed quarterly tax return is used to support the greater income stream.

The TOTAL Scorecard Refer recommendation requires a P&L and balance sheet, or income information directly from the IRS if both of the following conditions exist:

- more than seven months have elapsed since the business tax year's ending date, and
- income to the self-employed borrower from each individual business is greater than 5% of his/her stable monthly income.

References: For additional information on

- TOTAL Scorecard recommendations, see Page 13 of the [TOTAL Mortgage Scorecard User Guide](#), and
 - TOTAL Scorecard requirements for tax returns of self employed borrowers, see HUD 4155.1 4.D.4.d.
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4155.1 4.D.4.g Analyzing the Business's Financial Strength

To determine if the borrower's business is expected to generate sufficient income for his/her needs, the lender must carefully analyze the business's financial strength, including the

- source of the business's income
- general economic outlook for similar businesses in the area.

Annual earnings that are stable or increasing are acceptable, while businesses that show a significant decline in income over the analysis period are not acceptable, even if the current income and debt ratios meet FHA guidelines.

5. Income Analysis: Individual Tax Returns (IRS Form 1040)

Introduction This topic contains information on analyzing income for self employed borrowers through the review of IRS Form 1040, including

- adjusting income based on a review of IRS Form 1040, and
 - analyzing IRS Form 1040.
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**4155.1 4.D.5.a
Adjusting
Income Based
on Review of
IRS Form 1040** The amount shown on a borrower’s Internal Revenue Service (IRS) [Form 1040](#) as *adjusted gross income* (line 37) must either be increased or decreased based on the lender’s analysis of the individual tax return and any related tax schedules.

Reference: For particular items to analyze on IRS Form 1040, see HUD 4155.1 4.D.5.b.

**4155.1 4.D.5.b
Analyzing IRS
Form 1040** The table below contains guidelines for analyzing IRS [Form 1040](#).

| IRS Form 1040 Heading | Description |
|--------------------------|---|
| Wages, Salaries and Tips | <p>An amount shown under this heading may indicate that the individual</p> <ul style="list-style-type: none"> • is a salaried employee of a corporation, or • has other sources of income. <p>This section may also indicate that the spouse is employed, in which case the spouse’s income must be subtracted from the borrower’s adjusted gross income.</p> |

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5. Income Analysis: Individual Tax Returns (IRS Form 1040), Continued

4155.1 4.D.5.b Analyzing IRS Form 1040 (continued)

| IRS Form 1040 Heading | Description |
|---|--|
| Business Income and Loss (from Schedule C) | <p>Sole proprietorship income calculated on Schedule C is business income.</p> <p>Depreciation or depletion may be added back to the adjusted gross income.</p> |
| Rents, Royalties, Partnerships (from Schedule E) | Any income received from rental properties or royalties may be used as income, after adding back any depreciation shown on Schedule E. |
| Capital Gain and Losses (from Schedule D) | <p>Capital gains or losses generally occur only one time, and should not be considered when determining effective income.</p> <p>However, if the individual has a constant turnover of assets resulting in gains or losses, the capital gain or loss must be considered when determining the income. Three years' tax returns are required to evaluate an earning trend. If the trend</p> <ul style="list-style-type: none"> • results in a gain, it may be added as effective income, or • consistently shows a loss, it must be deducted from the total income. <p>The lender must document anticipated continuation of income through verified assets.</p> <p>Example: A lender can consider the capital gains as income for an individual who purchases old houses, remodels them, and sells them for profit.</p> |

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5. Income Analysis: Individual Tax Returns (IRS Form 1040), Continued

4155.1 4.D.5.b Analyzing IRS Form 1040 (continued)

| IRS Form 1040 Heading | Description |
|--|--|
| Interest and Dividend Income (from Schedule B) | <p>This taxable/tax-exempt income may be added back to the adjusted gross income only if it</p> <ul style="list-style-type: none"> • has been received for the past two years, and • is expected to continue. <p>If the interest-bearing asset will be liquidated as a source of the cash investment, the lender must appropriately adjust the amount.</p> |
| Farm Income or Loss (from Schedule F) | Any depreciation shown on Schedule F may be added back to the adjusted gross income. |
| IRA Distributions, Pensions, Annuities, and Social Security Benefits | The non-taxable portion of these items may be added back to the adjusted gross income, if the income is expected to continue for the first three years of the mortgage. |
| Adjustments to Income | <p>Adjustments to income may be added back to the adjusted gross income if they are</p> <ul style="list-style-type: none"> • IRA and Keogh retirement deductions • penalties on early withdrawal of savings • health insurance deductions, and • alimony payments. |
| Employee Business Expenses | Employee business expenses are actual cash expenses that must be deducted from the adjusted gross income. |

6. Income Analysis: Corporate Tax Returns (IRS Form 1120)

Introduction This topic contains information on analyzing corporate tax returns submitted on IRS Form 1120, including

- definition of *corporation*
 - obtaining borrower percentage of corporate ownership, and
 - analyzing corporate tax returns.
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**4155.1 4.D.6.a
Definition:
Corporation** A *corporation* is a state-chartered business owned by its stockholders.

**4155.1 4.D.6.b
Obtaining
Borrower
Percentage of
Corporate
Ownership** Corporate compensation to the officers, generally in proportion to the percentage of ownership, is shown on the

- corporate tax return (Internal Revenue Service (IRS) [Form 1120](#)), and
- individual tax returns.

When a borrower's percentage of ownership does not appear on the tax returns, the lender *must* obtain the information from the corporation's accountant, along with evidence that the borrower has the right to any compensation.

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6. Income Analysis: Corporate Tax Returns (IRS Form 1120), Continued

**4155.1 4.D.6.c
Analyzing
Corporate Tax
Returns**

In order to determine a self employed borrower’s income from a corporation, the adjusted business income must

- be determined, and
- multiplied by the borrower’s percentage of ownership in the business.

The table below describes the items found on IRS [Form 1120](#) for which an adjustment must be made in order to determine adjusted business income.

| Adjustment Item | Description of Adjustment |
|-------------------------------|--|
| Depreciation and Depletion | Add the corporation’s depreciation and depletion back to the after-tax income. |
| Taxable Income | Taxable income is the corporation’s net income before Federal taxes. Reduce taxable income by the tax liability. |
| Fiscal Year vs. Calendar Year | If the corporation operates on a fiscal year that is different from the calendar year, an adjustment must be made to relate corporate income to the individual tax return. |
| Cash Withdrawals | The borrower’s withdrawal of cash from the corporation may have a severe negative impact on the corporation’s ability to continue operating. |

7. Income Analysis: “S” Corporation Tax Returns (IRS Form 1120S)

Introduction This topic contains information on analyzing a self employed borrower’s income from an “S” corporation, including

- definition of “*S*” *corporation*, and
 - analyzing “S” corporation tax returns.
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Change Date March 1, 2011

**4155.1 4.D.7.a
Definition: “S”
Corporation** An “*S*” *corporation* is generally a small, start-up business, with gains and losses passed to stockholders in proportion to each stockholder’s percentage of business ownership.

Income for owners of “S” corporations comes from W-2 wages, and is taxed at the individual rate. The Internal Revenue Service (IRS) [Form 1120S](#), *Compensation of Officers* line item is transferred to the borrower’s individual [IRS Form 1040](#).

Reference: For information on reviewing and analyzing IRS Form 1040, see HUD 4155.1 4.D.5.

**4155.1 4.D.7.b
Analyzing “S”
Corporation
Tax Returns** “S” corporation depreciation and depletion may be added back to income in proportion to the borrower’s share of ownership in the corporation.

In addition, the income must also be reduced proportionately by the total obligations payable by the corporation in less than one year.

Important: The borrower’s withdrawal of cash from the corporation may have a severe negative impact on the corporation’s ability to continue operating, and must be considered in the income analysis.

8. Income Analysis: Partnership Tax Returns (IRS Form 1065)

Introduction This topic contains information on analyzing a self employed borrower's income from a partnership through the analysis of IRS Form 1065, including

- definition of partnership, and
 - analyzing partnership tax returns.
-

Change Date March 1, 2011

4155.1 4.D.8.a Definition: Partnership A *Partnership* is formed when two or more individuals form a business, and share in profits, losses, and responsibility for running the company.

Each partner pays taxes on his/her proportionate share of the partnership's net income.

4155.1 4.D.8.b Analyzing Partnership Tax Returns Both general and limited partnerships report income on Internal Revenue Service (IRS) [Form 1065](#), and the partners' share of income is carried over to [Schedule E](#) of [IRS Form 1040](#).

The lender must review IRS Form 1065 to assess the viability of the business. Both depreciation and depletion may be added back to the income in proportion to the borrower's share of income.

Income must also be reduced proportionately by the total obligations payable by the partnership in less than one year.

Important: Cash withdrawals from the partnership may have a severe negative impact on the partnership's ability to continue operating, and must be considered in the income analysis.

Reference: For information on reviewing IRS Form 1040, see HUD 4155.1 4.D.5.
