SPRINGBOARD
HOME LOANS

# Helping First-Time Home Buyers Who Are Self-Employed

Gardeners, taxi or Uber drivers, hair stylists, artists, freelancers, actors, recyclers, consultants, and other self-employed and small business owners face special challenges documenting their income when applying for a home mortgage. This report is designed for housing counselors, loan originators and real estate agents who want to help their self-employed clients prepare for homeownership.

## START WITH TAX RETURNS

Self-employment and business income are calculated using the average of the **NET**, taxable income reported on the borrower's two most recent filed federal income tax returns. This is the net business income which is usually reported on Form Schedule C and carried over to Line 12 of the form 1040.

Many self-employed persons tend to merge their business and personal finances and as a result the concept of "net" business income is often difficult to understand. For example, if their business generated $50,000 in gross business income in the prior year, they will tell the mortgage loan officer that they earned $50,000. However, when the tax return for that year is reviewed the loan officer will typically see that much of that business income has been excluded with business expenses and that the **NET**, **TAXABLE INCOME** is very low and sometimes a loss is even reported.

> **TIP:** It is important that the self-employment income reported be stable or increasing on a year over year basis. If the most recent tax year shows declining income, the underwriter will not allow the use of a two year average but instead require that an average of the most recent year only be used. It is also possible, the underwriter may determine that the income is not usable at all if the income decline is significant.

Mortgage underwriters use the average of the net, taxable income over the last two years as the borrower's qualifying income on the mortgage application. Therefore, if borrower reported net, taxable income that is very low or negative, the borrower's home buying power will be negligible or nonexistent.

Many self-employed, first-time home buyers are shocked when they learn that the federal tax returns they filed in the two most recent years will determine if they qualify to purchase a home now. Often they unknowingly allowed their tax preparer to claim aggressive business deductions as a means of reducing their tax liability. The self-employed applicant who finds themselves in this situation has two choices:

1. Wait two more years before purchasing home and during those years file federal tax returns that report sufficient net, taxable income to qualify for the desired home mortgage.

2. Amend the prior year returns by reporting additional net, self-employment income, file the returns and pay the taxes owed. Since lenders are required to verify the tax return provided by the borrowers directly with the IRS, the amended returns must actually be filed and increased taxes due must be paid.

When it comes to conventional and FHA underwriting rules, the self-employed borrower really has no choice but to prepare, file and pay taxes on federal tax returns that report sufficient, net taxable income to support the mortgage they seek - there is no other acceptable way to document their self-employment income.

## ESTABLISH A BUSINESS IDENTITY

The self-employed first-time home buyer should also be counseled to establish a verifiable business identity. This shows that the business is a serious endeavor and not a hobby. There are a number of low-cost and quick ways to do this including:

- Printing business cards
- Filing a DBA for the business
- Creating a simple business website
- Obtaining a local business license
- Open a business checking account and segregating personal and business expenses.
- Listing a business address and phone number in the local yellow pages

It is not necessary to take all of these steps but implementing as many as possible will be helpful in supporting the existence and stability of the self-employment income.

Please note that some lenders also require that the borrower obtain a letter from a CPA, bookkeeper or tax preparer confirming the existence of the self-employment or business income. Borrowers with informal business operations like lawn care and babysitting are unlikely to have a CPA or bookkeeper but they probably do have someone who prepares their taxes. This person could write a simple letter on their letterhead confirming that they have documented the business income on the borrower's tax filing.

## CREATE A YEAR-TO-DATE PROFIT AND LOSS STATEMENT

A year-to-date profit and loss statement is required to demonstrate that the income reported in the last tax filing is ongoing. The "P&L" statement can be self-prepared. It is not necessary to hire a professional. Obviously, if the borrower already has a bookkeeper or accountant, they can typically generate a current P&L statement very quickly.

A profit and loss statement is a simple report of income received by the business activity from all sources during the period covered. The statement also records all of the business related expenses during that same period. The net income (gross income minus expenses) is tallied at the bottom of the statement. The statement should be signed. For a mortgage loan application, the statement should cover the period from January 1st to through end of the last month before the application is submitted. For example if the loan application is submitted May 15th, the P&L statement should cover January 1 through April 30.

On the next page is actual profit and loss statement for a self-employed first-time buyer who does occasional work in the hip-hop music industry.

# EXAMPLE PROFIT AND LOSS STATEMENT

| |
|---|
| Doing Business As (DBA): |
| Doing Business As (DBA): |
| Business Name |
| Business Address |
| City, State, Zip |
| SS or TIN # |

**PROFIT & LOSS STATEMENT**
January 1, 2016 - April 30, 2016

| | |
|---|---|
| **GROSS REVENUE** | |
| Sales and Licensing Fees | $ 7,624.00 |
| **Total Revenue** | **$ 7,624.00** |
| | |
| **EXPENSES** | |
| Equipment | $ 422.44 |
| Marketing | $ 111.11 |
| Telephone | $ 155.56 |
| Internet | $ 435.56 |
| Transportation | $ 1,000.00 |
| Supplies & Materials | $ 393.33 |
| **Total Expenses** | **$ 2,518.00** |
| | |
| Net Revenue | **$ 5,106.00** |
| | |
| Monthly Average | **$ 1,276.50** |
| | |
| **ANNUAL PROJECTED** | **$ 15,318.00** |
| **APPROVED** | |

Home Buyer Signature ____________________________________________