K1s: Are Distributions Enough?  
A New Look at Partnerships and S-Corps
Before We Begin

• Materials Needed
• Mute Phones
• Questions
• Max View
• Polling Questions
Objectives

• Understand the GSE guidelines for analyzing income for Partnerships and S-Corps

• Discuss the importance of distributions

• List the requirements for documenting business liquidity

• Analyze income from Partnerships and S-Corps

How We Got Here

October 2001

SEL-2014-16

Selling Notice March 2015

SEL-2015-09
What is the Debate About?

<table>
<thead>
<tr>
<th></th>
<th>Ordinary business income (loss)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>100,000.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Distributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>19</td>
<td></td>
</tr>
</tbody>
</table>

Bill Smith – Smith Potato

Bill Needs a monthly qualifying income of: $7,230.00
Pass Through Taxation

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

For tax year 2014, or the
year beginning

Partner’s Share of Income, Deductions, Credits, etc.

Part I Information About the Partner

A. Partnership’s identification number
B. Partnership name, address, city, state, and ZIP code
C. IRS Center where partnership filed return
D. Check this is a qualified partnership (check)

Part II Pass Through Income and Loss

Measure of income and loss

189,624.00

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Pass Through Taxation

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Why are the Numbers Different?

Smith Potato
Bill’s share of the profit in 2014 = $199,622

Balance = $36,125

What number do we use?

Schedule K-1 (Form 1065)
Partner’s Share of Income, Deductions, Credits, etc.

Part 1 Information About the Business

Partner’s Share of Income, Deductions, Credits, etc.

Line 13a Profit or (Loss) from Business (Enter “–” (minus) if a loss.) $199,622

Line 14d Balance = $36,125
1084 Instructions

If the Schedule K-1 reflects a documented, stable history of receiving cash distributions of income from the business consistent with the level of business income being used to qualify, then no further documentation of access to income or adequate business liquidity to support the withdrawal of earning is required in order to include that income in the borrower’s cash flow.

Box 19 - Distributions
### Box 19 - Distributions

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount 1</th>
<th>Amount 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Ordinary Income (Loss), Net Income (Loss) OR Distributions - see comments</td>
<td>$36,126.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>2. Guaranteed Payments to Partner</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td><strong>Subtotal Section VIII</strong></td>
<td>$36,126.00</td>
<td>$0.00</td>
</tr>
</tbody>
</table>

### Box 4 – Guaranteed Payments to Partner

- **Guaranteed Payments**: $0.00
### Box 4 – Guaranteed Payments to Partner

#### VIII. Partners Share of Income - Schedule K-1 (Form 1065)
1. Ordinary Income (Loss), Net Income (Loss) OR
   - Distributions - see comments
   - Guaranteed Payments to Partner
   - Subtotal: $86,125.00

#### IX. Shareholders Share of Income - Schedule K-1 (Form 1120)
1. Ordinary Income (Loss), Net Income (Loss) OR
   - Distributions - see comments
   - Subtotal: $0.00

**Total Personal Income Tax:** $86,125.00

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### Form 1065

#### VIII. Partners Share of Income - Schedule K-1 (Form 1065)
1. Ordinary Income (Loss), Net Income (Loss) OR
   - Distributions - see comments
   - Guaranteed Payments to Partner
   - Subtotal: $86,125.00

**Total Personal Income Tax:** $86,125.00

#### X. Partnership (Form 1065)
1. Pass-Through Income (Loss)
   - Total Partner’s Share of Income
   - Subtotal: $19,399.50

**Bill Needs a monthly qualifying income of:** $7,230.00

**Bill Has a monthly qualifying income of:** $8,010.42
Tyson needs $7,800 to qualify
Tyson has a monthly income of $7,800 to qualify

Tyson has a monthly income of $4,177.42
# Form 1120S – Adjustments to Cash Flow

## Schedule M-1
Reconciliation of Income (Loss) per Books With Income (Loss) per Return

- Income and expenses that were not included in Schedule K, line 1 through 12 and 14 were included in line 15.

## Schedule M-2
Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders’ Undistributed Taxable Income Previously Taxed

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Expenses</td>
<td>$22,324</td>
</tr>
<tr>
<td>Bank Charges</td>
<td>7,466</td>
</tr>
<tr>
<td>Commissions</td>
<td>395,513</td>
</tr>
<tr>
<td>Dues and Subscriptions</td>
<td>4,217</td>
</tr>
<tr>
<td>Freight Expenses</td>
<td>134,076</td>
</tr>
<tr>
<td>Insurance</td>
<td>115,893</td>
</tr>
<tr>
<td>Medical Expenses - Employee Legal &amp; Accounting</td>
<td>33,649</td>
</tr>
<tr>
<td>Office Supplies</td>
<td>26,635</td>
</tr>
<tr>
<td>Postage Expenses</td>
<td>3,057</td>
</tr>
<tr>
<td>General Supplies</td>
<td>18,529</td>
</tr>
<tr>
<td>Telephone</td>
<td>21,406</td>
</tr>
<tr>
<td>Travel Expenses</td>
<td>42,303</td>
</tr>
<tr>
<td>Utilities</td>
<td>9,311</td>
</tr>
<tr>
<td>Miscellaneous Expense</td>
<td>13,347</td>
</tr>
<tr>
<td>Contract Labor</td>
<td>46,821</td>
</tr>
<tr>
<td>Fuel Expense</td>
<td>105,736</td>
</tr>
<tr>
<td>Hand Tools</td>
<td>3,449</td>
</tr>
<tr>
<td>Computer Installation Costs</td>
<td>2,351</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>10,560</td>
</tr>
<tr>
<td>50% of Meals &amp; Entertainment</td>
<td>12,973</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,089,480</strong></td>
</tr>
</tbody>
</table>
If the Schedule K1 does not reflect a documented, stable history of receiving cash distributions of income from the business consistent with the level of business income being used to qualify, then the lender must confirm the following:

• the borrower can document access to the income
• the business has adequate liquidity to support the withdrawal of earnings

The lender is not required to confirm access to the income when the borrower(s) own 100% of the business.
Can We Use Box 1 for Tyson?

Can Tyson document access to the income?

For borrowers that do not own 100%, the lender must confirm access to the income via a partnership agreement, corporate resolution or other documentation.

Can We Use Box 1 for Tyson?

Can Tyson document access to the income?

Does the business have adequate liquidity to support the withdrawal of earnings?
Assess Business Liquidity

Current Assets - Inventory

Current Liabilities

Current Liquidity

OR

Current Assets - Inventory

Current Liabilities

Quick Ratio for Liquidity

Document Business Liquidity

Schedule L – Balance Sheets per Books from the IRS Form 1065 or 1120-S

If the business tax returns are not required or the returns do not accurately represent the current financial status of the business,

Current YTD balance sheet and/or other financial statements
Schedule L

<table>
<thead>
<tr>
<th>Asset Description</th>
<th>Column A</th>
<th>Column B</th>
<th>Column C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade notes and accounts receivable</td>
<td>873,370</td>
<td>848,242</td>
<td></td>
</tr>
<tr>
<td>Loans receivable</td>
<td>458,000</td>
<td>390,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>10,000</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities and Shareholders' Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>545,519</td>
<td>575,432</td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td>25,000</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Total liabilities and shareholders' equity</td>
<td>1,120,848</td>
<td>1,120,848</td>
<td></td>
</tr>
</tbody>
</table>

Current Ratio

<table>
<thead>
<tr>
<th>Description</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$262,462.00</td>
</tr>
<tr>
<td>Trade notes and accounts receivable</td>
<td>$848,242.00</td>
</tr>
<tr>
<td>Inventories</td>
<td>$525,000.00</td>
</tr>
<tr>
<td>Total Current Assets</td>
<td>$1,655,704.00</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>$375,433.00</td>
</tr>
<tr>
<td>Mortgages notes bond payable &lt; 1 year</td>
<td>$0.00</td>
</tr>
<tr>
<td>Other current liabilities</td>
<td>$66,887.00</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
<td>$442,320.00</td>
</tr>
<tr>
<td>Current Ratio</td>
<td>3.70</td>
</tr>
</tbody>
</table>
Quick Ratio

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
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<td><strong>Cash</strong></td>
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</tr>
<tr>
<td><strong>Trade notes and accounts receivable</strong></td>
<td>$848,242.00</td>
</tr>
<tr>
<td><strong>Inventories</strong></td>
<td>$529,000.00</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>$1,639,704.00</td>
</tr>
<tr>
<td><strong>Accounts Payable</strong></td>
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</tr>
<tr>
<td><strong>Mortgages notes bond payable &lt; 1 year</strong></td>
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</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
<td>$442,320.00</td>
</tr>
</tbody>
</table>

**Quick Ratio** 2.51

Ratios

- Current Ratio Standard 2:1
- Quick Ratio Standard 1:1
Current Ratio or Quick Ratio

Can Tyson document access to the income?  

Does the business have adequate liquidity to support the withdrawal of earnings?

Form 1120s – Adjustments to Cash Flow

IX. Shareholders’ Share of Income - Schedule K-1 (Form 1120s)

1. Ordinary income (loss), Net income (loss) OR Distributions - See comments... $241,202.00  $0.00

Total Personal Income Tax $241,202.00  $0.00

X. E-Corporation (Form 1120s)

1. Non-recognizing Other Income (Loss) $241,202.00  $0.00

2. Depreciation $218,000.00  $0.00

3. Dividends $0.00  $0.00

4. Amortization/Capital Loss/One Time Expense $13,200.00  $0.00

5. Mortgage/Note Payable in Less than 2 Year $0.00  $0.00

6. Non-deductible Meals and Entertainment Exclusion $14,520.00  $0.00

7. Subtotal $34,290.00  $0.00

8. Ownership Percentage Listed on Schedule K-1 100.00  0.00

9. Total Shareholders' Income from S-Corp $34,290.00  $0.00

Totals $241,202.00  $0.00

1. Rental Tax Returns $0.00  $0.00

2. Partnership Return $0.00  $0.00

3. S-Corporation Return $241,202.00  $0.00

4. Corporation Return $0.00  $0.00

5. Total Income from Tax Returns $241,202.00  $0.00

# of months to determine average monthly income: 12

Applicable income during total first year $241,202.00

Applicable income grand total second year $0.00

Monthly income $241,202.00
What Does Freddie Mac Say?

“Use of this income is allowed if the tax returns evidence that the partnership is showing positive earning trend and liquidity, the Borrower provides a resolution reflecting the Borrower’s access to income and the income is not already reported on the Borrower’s personal tax returns.”

THANK YOU

for your attention and for making Essent Guaranty your MI choice.