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Voices Providing guidance to obtain financing for the self-employed

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There is an old adage, “Banks will only lend money to people who don’t need it.” Well, what if your self-employed clients do need access to capital? On one hand they will want to reduce as much of their self-employed income that the tax laws allow; however, they are going to need to show a bank underwriter sufficient verifiable income needed to support a loan. A conundrum indeed. There’s a strategy that’s been useful to help many clients achieve their financial objectives, while providing the tangible security required by the lender.

In order to determine how much income will be needed to declare, first determine how much money is owed in the form of mortgages, installment loans and revolving debt. These figures are obtained by running the individual’s credit report. Fannie Mae and Freddie Mac have strict guidelines with regard to allowable debt, which is determined by calculating two ratios:

1. Front-end or housing ratio: A housing payment cannot be more than 45 percent of the gross monthly income. This includes the client’s principal, interest, property taxes and homeowners insurance (flood insurance as well, if needed).

2. Back-end ratio: This ratio cannot exceed 50 percent of gross monthly income. This debt includes housing payments, car loans, student loans, minimum payments to credit cards, and mortgages on second homes.

The second step is to determine the size of the loan needed to accomplish the client’s goal. The payoff amounts for the mortgages will be on the credit report. Approximate the closing costs, escrows and the amount of proceeds back to the borrower, if needed. Once you have a loan amount, it needs to be priced based on current interest rates.

So, how do all these calculations benefit the self-employed borrower? For our clients, we run all the information through a proprietary computerized underwriting system before we apply. These findings will be accepted by any bank as long as we get what we call a desktop approval, which for self-employed borrowers will require only one year of tax returns, as opposed to the usual two- year average for most borrowers. The borrower must have been in the business for a minimum of two years as well as show six months of reserves in their bank accounts. The point here is to plan ahead and get the approval the first time around, as you only have one opportunity to make a good first impression and the last thing you want is to have your client initially turned down.

This is where coordination with the tax planner comes into play as this strategy requires some forethought and planning to prepare. Based on the previous year's declared income, it is unlikely that sufficient income was reported to qualify for the loan. We give the income number we calculated above to the tax preparer to plan with the client for the upcoming tax year. Then at the beginning of the year, this number is used to file the taxes. Yes, the borrower has to bite the bullet and pay the taxes on this income for just one year, but it is necessary to obtain the desired goal. One word of caution: The income taxes owed have to be paid prior to closing. If they enter into an IRS repayment plan, that monthly figure is included in the overall debt-to-income ratio and may reduce the amount of the loan.

To illustrate this further, a client who was recently referred through his CPA needed money to fund a home improvement project, as well as consolidate two mortgages he currently has on his home, three cars and 95,000 of student debt, all totaling $670,000.

The first step was to run his credit to determine his obligations, which were substantial. He had two mortgages totaling $525,000, three automobiles, $95,000 in deferred student loans, as well as assorted credit card debt. To fit into the ratios described above, he would have had to declare a significant amount of income to support the overall debt.

As long as we were able to prove the cars were paid for by the business, they were taken out of the equation. Even though the student loan was deferred, the bank underwriters must take them into account. Guidelines state they must use 1 percent of the loan balance ($950) or a 30-year amortized payment, whichever is less. Utilizing the lower 30-year figure obtained from Sallie Mae, along with a lower monthly mortgage, and paying off the credit card debt, enabled him to significantly reduce his monthly obligation, thereby reducing the amount of income he needed to report as taxable income to the IRS.

Since no strategy is one size fits all, oftentimes other programs are employed to accomplish the same goal. For example:

1. Bank statement program: If a business owner has a large cash flow from their business, we can take the average deposits from the past 12 months to use as qualifying income.

2. Asset-dissipation loan: This program determines qualifying income by utilizing their existing assets, both business and personal. Assets do not need to be depleted in order to qualify.

Creativity within the allowable guidelines is necessary in order to find the best option to benefit the individual small business owner or self-employed borrower.

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