

Federal Compliance / Truth in Lending Act / Regulations / Regulation Z - Truth In Lending (12 CFR Part 1026) (01/18/14) / Part 1026, Appendix Q: Standards for Determining Monthly Debt and Income (01/10/14)**Part 1026, Appendix Q: Standards for Determining Monthly Debt and Income (01/10/14)**

Appendix Q to Part 1026—Standards for Determining Monthly Debt and Income Section 1026.43(e)(2)(vi) provides that, to satisfy the requirements for a qualified mortgage under § 1026.43(e)(2), the ratio of the consumer's total monthly debt payments to total monthly income at the time of consummation cannot exceed 43 percent. Section 1026.43(e)(2)(vi)(A) requires the creditor to calculate the ratio of the consumer's total monthly debt payments to total monthly income using the following standards, with additional requirements for calculating debt and income appearing in § 1026.43(e)(2)(vi)(B). Where guidance issued by the U.S. Department of Housing and Urban Development, the U.S. Department of Veterans Affairs, the U.S. Department of Agriculture, or the Rural Housing Service, or issued by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) while operating under the conservatorship or receivership of the Federal Housing Finance Agency, or issued by a limited-life regulatory entity succeeding the charter of either Fannie Mae or Freddie Mac (collectively, Agency or GSE guidance) is in accordance with appendix Q, creditors may look to that guidance as a helpful resource in applying appendix Q. Moreover, when the following standards do not resolve how a specific kind of debt or income should be treated, the creditor may either (1) exclude the income or include the debt, or (2) rely on Agency or GSE guidance to resolve the issue. The following standards resolve the appropriate treatment of a specific kind of debt or income where the standards provide a discernible answer to the question of how to treat the debt or income. However, a creditor may not rely on Agency or GSE guidance to reach a resolution contrary to that provided by the following standards, even if such Agency or GSE guidance specifically addresses the particular type of debt or income but the following standards provide more generalized guidance.

I. CONSUMER EMPLOYMENT RELATED INCOME

A. *Stability of Income*

1. *Effective Income.* Income may not be used in calculating the consumer's debt-to-income ratio if it comes from any source that cannot be verified, is not stable, or will not continue.

2. *Verifying Employment History.*

a. The creditor must verify the consumer's employment for the most recent two full years, and the creditor must require the consumer to:

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

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

NOTE: A consumer with a 25 percent or greater ownership interest in a business is considered self-employed and will be evaluated as a self-employed consumer.

3. *Analyzing a Consumer's Employment Record.*

a. When analyzing a consumer's employment, creditors must examine:

- i. The consumer's past employment record; and
- ii. The employer's confirmation of current, ongoing employment status.

NOTE: Creditors may assume that employment is ongoing if a consumer's employer verifies current employment and does not indicate that employment has been, or is set to be terminated. Creditors should not rely upon a verification of current employment that includes an affirmative statement that the employment is likely to cease, such as a statement that indicates the employee has given (or been given) notice of employment suspension or termination.

b. Creditors may favorably consider the stability of a consumer's income 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.

4. *Consumers Returning to Work After an Extended Absence.* A consumer's income may be considered effective and stable when recently returning to work after an extended absence if he/she:
- a. Is employed in the current job for six months or longer; and
 - b. Can document a two year work history prior to an absence from employment using:
 - i. Traditional employment verifications; and/or
 - ii. Copies of IRS Form W-2s or pay stubs.

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

- c. Important: Situations not meeting the criteria listed above may not be used in qualifying. Extended absence is defined as six months.

B. *Salary, Wage and Other Forms of Income*

1. *General Policy on Consumer Income Analysis.*

- a. The income of each consumer who will be obligated for the mortgage debt and whose income is being relied upon in determining ability to repay must be analyzed to determine whether his/her income level can be reasonably expected to continue.
- b. In most cases, a consumer's income is limited to salaries or wages. Income from other sources can be considered as effective, when properly verified and documented by the creditor.

NOTES:

- i. Effective income for consumers planning to retire during the first three-year period must include the amount of:
 - a. Documented retirement benefits;
 - b. Social Security payments; or
 - c. Other payments expected to be received in retirement.
- ii. Creditors must not ask the consumer about possible, future maternity leave.
- iii. Creditors may assume that salary or wage income from employment verified in accordance with section I.A.3 above can be reasonably expected to continue if a consumer's employer verifies current employment and income and does not indicate that employment has been, or is set to be terminated. Creditors should not assume that income can be reasonably expected to continue if a verification of current employment includes an affirmative statement that the employment is likely to cease, such as a statement that indicates the employee has given (or been given) notice of employment suspension or termination.

2. *Overtime and Bonus Income.*

- a. Overtime and bonus income can be used to qualify the consumer if he/she has received this income for the past two years, and documentation submitted for the loan does not indicate this income will likely cease. If, for example, the employment verification states that the overtime and bonus income is unlikely to continue, it may not be used in qualifying.
- b. The creditor 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 creditor can justify and document in writing the reason for using the income for qualifying purposes.

3. *Establishing an Overtime and Bonus Income Earning Trend.*

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

4. *Qualifying Part-Time Income.*

- a. Part-time and seasonal income can be used to qualify the consumer if the creditor documents that the consumer 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 creditors should not restrict consideration of such income when qualifying the income of these consumers.
- b. Part-time income received for less than two years may be included as effective income, provided that the creditor justifies and documents that the income is likely to continue.
- c. Part-time income not meeting the qualifying requirements may not be used in qualifying.

NOTE: For qualifying purposes, "part-time" income refers to employment taken to supplement the consumer's income from regular employment; part-time employment is not a primary job and it is worked less than 40 hours.

5. *Income from Seasonal Employment.*

- a. Seasonal income is considered uninterrupted, and may be used to qualify the consumer, if the creditor documents that the consumer:
 - i. Has worked the same job for the past two years, and
 - ii. Expects to be rehired the next season.
- b. Seasonal employment includes, but is not limited to:
 - i. Umpiring baseball games in the summer; or
 - ii. Working at a department store during the holiday shopping season.

6. *Primary Employment Less Than 40 Hour Work Week.*

- a. When a consumer's primary employment is less than a typical 40-hour work week, the creditor should evaluate the stability of that income as regular, on-going primary employment.
- b. 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 consumer's primary employment, and should be considered effective income.

7. *Commission Income.*

- a. Commission income must be averaged over the previous two years. To qualify commission income, the consumer must provide:
 - i. Copies of signed tax returns for the last two years; and
 - ii. The most recent pay stub.
- b. Consumers whose commission income was received for more than one year, but less than two years may be considered favorably if the underwriter can:
 - i. Document the likelihood that the income will continue, and
 - ii. Soundly rationalize accepting the commission income.

NOTES:

- i. Unreimbursed business expenses must be subtracted from gross income.
- ii. A commissioned consumer is one who receives more than 25 percent of his/her annual income from commissions.
- iii. A tax transcript obtained directly from the IRS may be used in lieu of signed tax returns.

8. *Qualifying Commission Income Earned for Less Than One Year.*

- a. Commission income earned for less than one year is not considered effective income. Exceptions may be made for situations in which the consumer's compensation was changed from salary to commission within a similar position with the same employer.
- b. A consumer's income may also qualify when the portion of earnings not attributed to commissions would be sufficient to qualify the consumer for the mortgage.

9. *Employer Differential Payments.*

If the employer subsidizes a consumer's mortgage payment through direct payments, the amount of the payments:

- a. Is considered gross income, and
- b. Cannot be used to offset the mortgage payment directly, even if the employer pays the servicing creditor directly.

10. *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)'s, will cease within the first full three years of the mortgage loan, such income may not be used in qualifying.

11. *Social Security Income.*

Social Security income must be verified by a Social Security Administration benefit verification letter (sometimes called a "proof of income letter," "budget letter," "benefits letter," or "proof of award letter"). If any benefits expire within the first full three years of the loan, the income source may not be used in qualifying.

NOTES:

- i. If the Social Security Administration benefit verification letter does not indicate a defined expiration date within three years of loan origination, the creditor shall consider the income effective and likely to continue. Pending or current re-evaluation of medical eligibility for benefit payments is not considered an indication that the benefit payments are not likely to continue.
- ii. Some portion of Social Security income may be "grossed up" if deemed nontaxable by the IRS.

12. *Automobile Allowances and Expense Account Payments.*

- a. Only the amount by which the consumer's automobile allowance or expense account payments exceed actual expenditures may be considered income.
- b. To establish the amount to add to gross income, the consumer must provide the following:
 - i. IRS Form 2106, Employee Business Expenses, for the previous two years; and
 - ii. Employer verification that the payments will continue.
- c. If the consumer 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.
- d. Expenses that must be treated as recurring debt include:
 - i. The consumer's monthly car payment; and
 - ii. Any loss resulting from the calculation of the difference between the actual expenditures and the expense account allowance.

C. *Consumers Employed by a Family Owned Business.*

1. *Income Documentation Requirement.*

In addition to normal employment verification, a consumer employed by a family owned business is required to provide evidence that he/she is not an owner of the business, which may include:

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

NOTE: A tax transcript obtained directly from the IRS may be used in lieu of signed tax returns.

D. *General Information on Self-Employed Consumers and Income Analysis.*

1. *Definition: Self-Employed Consumer.*

A consumer with a 25 percent or greater ownership interest in a business is considered self-employed.

2. *Types of Business Structures.*

There are four basic types of business structures. They include:

- a. Sole proprietorships;
- b. Corporations;
- c. Limited liability or "S" corporations; and
- d. Partnerships.

3. *Minimum Length of Self Employment.*

- a. Income from self-employment is considered stable, and effective, if the consumer has been self-employed for two or more years.
- b. 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 consumers who have been self-employed for less than two years.

If the period of self-employment is:	Then:
Between one and two years	<p>For the individual's income to be effective, the individual must at least two years of documented previous successful employment in the line of work in which the individual is self-employed, or in a related occupation.</p> <p>Note: A combination of one year of employment and formal education or training in the line of work the individual is self-employed or related occupation is also acceptable.</p>
Less than one year	The income from the consumer may not be considered effective income.

4. *General Documentation Requirements for Self-Employed Consumers.*

Self-employed consumers must provide the following documentation:

- a. Signed, dated individual tax returns, with all applicable tax schedules for the most recent two years;
- b. 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; and
- c. Year to date profit and loss (P&L) statement and balance sheet.

5. *Establishing a Self-Employed Consumer's Earnings Trend.*

- a. When qualifying income, the creditor must establish the consumer's earnings trend from the previous two years using the consumer's tax returns.
- b. If a consumer:
 - i. Provides quarterly tax returns, the income analysis may include income through the period covered by the tax filings, or
 - ii. 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.
- c. 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 creditor must base the income analysis solely on the income verified through the tax returns.
- d. If the consumer'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 consumer's most recent year's tax return or P&L must be used to calculate his/her income.

6. *Analyzing the Business's Financial Strength.*

The creditor must consider the business's financial strength by examining annual earnings. 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.

E. *Income Analysis: Individual Tax Returns (IRS Form 1040).*1. *General Policy on Adjusting Income Based on a Review of IRS Form 1040.*

The amount shown on a consumer's IRS Form 1040 as adjusted gross income must either be increased or decreased based on the creditor's analysis of the individual tax return and any related tax schedules.

2. *Guidelines for Analyzing IRS Form 1040.*

The table below contains guidelines for analyzing IRS Form 1040:

IRS Form 1040 heading	Description
Wages, Salaries and Tips	An amount shown under this heading may indicate that the individual: <ul style="list-style-type: none"> • Is a salaried employee of a corporation, or • Has other sources of income. This section may also indicate that the spouse is employed, in which case the spouse's income must be subtracted from the consumer's adjusted gross income.
Business Income and Loss (from Schedule C)	Sole proprietorship income calculated on Schedule C is business income. Depreciation or depletion may be added back to the adjusted gross income.
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)	Capital gains or losses generally occur only one time, and should not be considered when determining effective income. 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: <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. Creditor must document anticipated continuation of income through verified assets. <p><i>Example:</i> A creditor can consider the capital gains for an individual who purchases old houses, remodels them, and sells them for profit.</p>
Interest and Dividend Income (from Schedule B)	This taxable/tax-exempt income may be added back to the adjusted gross income only if it: <ul style="list-style-type: none"> • Has been received for the past two years; and • Is expected to continue. If the interest-bearing asset will be liquidated as a source of the cash investment, the creditor must appropriately adjust the amount.
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	Adjustments to income may be added back to the adjusted gross income if they are: <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.

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

1. *Description: Corporation.*

A corporation is a State-chartered business owned by its stockholders.

2. *Need To Obtain Consumer Percentage of Ownership Information.*

- a. Corporate compensation to the officers, generally in proportion to the percentage of ownership, is shown on the:
 - i. Corporate tax return IRS Form 1120; and
 - ii. Individual tax returns.
- b. When a consumer's percentage of ownership does not appear on the tax returns, the creditor must obtain the information from the corporation's accountant, along with evidence that the consumer has the right to any compensation.

3. *Analyzing Corporate Tax Returns.*

- a. In order to determine a consumer's self-employed income from a corporation the adjusted business income must:
 - i. Be determined; and
 - ii. Multiplied by the consumer's percentage of ownership in the business.
- b. 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 consumer's withdrawal of cash from the corporation may have a severe negative impact on the corporation's ability to continue operating.

G. *Income Analysis: "S" Corporation Tax Returns (IRS Form 1120S).*

1. *Description: "S" Corporation.*

- a. 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.
- b. Income for owners of "S" corporations comes from IRS Form W-2 wages, and is taxed at the individual rate. The IRS Form 1120S, Compensation of Officers line item is transferred to the consumer's individual IRS Form 1040.

2. *Analyzing "S" Corporation Tax Returns.*

- a. "S" corporation depreciation and depletion may be added back to income in proportion to the consumer's share of the corporation's income.
- b. In addition, the income must also be reduced proportionately by the total obligations payable by the corporation in less than one year.
- c. Important: The consumer'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.

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

1. *Description: Partnership.*

- a. A partnership is formed when two or more individuals form a business, and share in profits, losses, and responsibility for running the company.
- b. Each partner pays taxes on his/her proportionate share of the partnership's net income.

2. *Analyzing Partnership Tax Returns.*

- a. Both general and limited partnerships report income on IRS Form 1065, and the partners' share of income is carried over to Schedule E of IRS Form 1040.
- b. The creditor 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 consumer's share of income.
- c. Income must also be reduced proportionately by the total obligations payable by the partnership in less than one year.
- d. 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.

II. NON-EMPLOYMENT RELATED CONSUMER INCOME

A. *Alimony, Child Support, and Maintenance Income Criteria.*

Alimony, child support, or maintenance income may be considered effective, if:

1. Payments are likely to be received consistently for the first three years of the mortgage;
2. The consumer provides the required documentation, which includes a copy of the:
 - i. Final divorce decree;
 - ii. Legal separation agreement;
 - iii. Court order; or
 - iv. Voluntary payment agreement; and
3. The consumer can provide acceptable evidence that payments have been received during the last 12 months, such as:
 - i. Cancelled checks;
 - ii. Deposit slips;
 - iii. Tax returns; or
 - iv. Court records.

NOTES:

- i. Periods less than 12 months may be acceptable, provided the creditor can adequately document the payer's ability and willingness to make timely payments.
- ii. Child support may be "grossed up" under the same provisions as non-taxable income sources.

B. *Investment and Trust Income.*

1. *Analyzing Interest and Dividends.*

- a. Interest and dividend income may be used as long as tax returns or account statements support a two-year receipt history. This income must be averaged over the two years.
- b. Subtract any funds that are derived from these sources, and are required for the cash investment, before calculating the projected interest or dividend income.

2. *Trust Income.*

- a. Income from trusts may be used if constant payments will continue for at least the first three years of the mortgage term as evidenced by trust income documentation.
- b. Required trust income documentation includes a copy of the Trust Agreement or other trustee statement, confirming the:
 - i. Amount of the trust;
 - ii. Frequency of distribution; and
 - iii. Duration of payments.
- c. Trust account funds may be used for the required cash investment if the consumer provides adequate documentation that the withdrawal of funds will not negatively affect income. The consumer may use funds from the trust account for the required cash investment, but the trust income used to determine repayment ability cannot be affected negatively by its use.

3. *Notes Receivable Income.*

- a. In order to include notes receivable income, the consumer must provide:
 - i. A copy of the note to establish the amount and length of payment, and
 - ii. Evidence that these payments have been consistently received for the last 12 months through deposit slips, deposit receipts, cancelled checks, bank or other account statements, or tax returns.
- b. If the consumer is not the original payee on the note, the creditor must establish that the consumer is able to enforce the note.

4. *Eligible Investment Properties.*

Follow the steps in the table below to calculate an investment property's income or loss if the property to be subject to a mortgage is an eligible investment property.

1	<p>Subtract the monthly payment(PITI) from the monthly net rental income of the subject property.</p> <p>Note: Calculate the monthly net rental by taking the gross rents, and subtracting the 25 percent reduction for vacancies and repairs.</p>
2	<p>Does the calculation in Step 1 yield a positive number?</p> <ul style="list-style-type: none">• If <i>yes</i>, add the number to the consumer's monthly gross income.• If <i>no</i>, and the calculation yields a negative number, consider it a recurring monthly obligation.

C. *Military, Government Agency, and Assistance Program Income.*

1. *Military Income.*

- a. Military personnel not only receive base pay, but often times are entitled to additional forms of pay, such as:
 - i. Income from variable housing allowances;
 - ii. Clothing allowances;
 - iii. Flight or hazard pay;
 - iv. Rations; and
 - v. Proficiency pay.
- b. These types of additional pay are acceptable when analyzing a consumer's income as long as the probability of such pay to continue is verified in writing.

NOTE: The tax-exempt nature of some of the above payments should also be considered.

2. *VA Benefits.*

- a. Direct compensation for service-related disabilities from the Department of Veterans Affairs (VA) is acceptable, provided the creditor receives documentation from the VA.
- b. Education benefits used to offset education expenses are not acceptable.

3. *Government Assistance Programs.*

- a. Income received from government assistance programs is acceptable as long as the paying agency provides documentation indicating that the income is expected to continue for at least three years.
- b. If the income from government assistance programs will not be received for at least three years, it may not be used in qualifying.
- c. Unemployment income must be documented for two years, and there must be reasonable assurance that this income will continue. This requirement may apply to seasonal employment.

NOTE: Social Security income is acceptable as provided in section I.B.11.

4. *Mortgage Credit Certificates.*

- a. If a government entity subsidizes the mortgage payments either through direct payments or tax rebates, these payments may be considered as acceptable income.
- b. Either type of subsidy may be added to gross income, or used directly to offset the mortgage payment, before calculating the qualifying ratios.

5. *Homeownership Subsidies.*

- a. A monthly subsidy may be treated as income, if a consumer is receiving subsidies under the housing choice voucher home ownership option from a public housing agency (PHA). Although continuation of the homeownership voucher subsidy beyond the first year is subject to Congressional appropriation, for the purposes of underwriting, the subsidy will be assumed to continue for at least three years.
- b. If the consumer is receiving the subsidy directly, the amount received is treated as income. The amount received may also be treated as nontaxable income and be "grossed up" by 25 percent, which means that the amount of the subsidy, plus 25 percent of that subsidy may be added to the consumer's income from employment and/or other sources.
- c. Creditors may treat this subsidy as an "offset" to the monthly mortgage payment (that is, reduce the monthly mortgage payment by the amount of the home ownership assistance payment before dividing by the monthly income to determine the payment-to-income and debt-to-income ratios). The subsidy payment must not pass through the consumer's hands.
- d. The assistance payment must be:
 - i. Paid directly to the servicing creditor; or
 - ii. Placed in an account that only the servicing creditor may access.

NOTE: Assistance payments made directly to the consumer must be treated as income.

D. *Rental Income.*

1. *Analyzing the Stability of Rental Income.*

- a. Rent received for properties owned by the consumer is acceptable as long as the creditor can document the stability of the rental income through:
 - i. A current lease;
 - ii. An agreement to lease; or
 - iii. A rental history over the previous 24 months that is free of unexplained gaps greater than three months (such gaps could be explained by student, seasonal, or military renters, or property rehabilitation).
- b. A separate schedule of real estate is not required for rental properties as long as all properties are documented on the Uniform Residential Loan Application.

NOTE: The underwriting analysis may not consider rental income from any property being vacated by the consumer, except under the circumstances described below.

2. *Rental Income From Consumer Occupied Property.*

- a. The rent for multiple unit property where the consumer resides in one or more units and charges rent to tenants of other units may be used for qualifying purposes.
- b. Projected rent for the tenant-occupied units only may:
 - i. Be considered gross income, only after deducting vacancy and maintenance factors, and
 - ii. Not be used as a direct offset to the mortgage payment.

3. *Income from Roommates or Boarders in a Single Family Property.*

- a. Rental income from roommates or boarders in a single family property occupied as the consumer's primary residence is acceptable.
- b. The rental income may be considered effective if shown on the consumer's tax return. If not on the tax return, rental income paid by the roommate or boarder may not be used in qualifying.

4. *Documentation Required To Verify Rental Income.*

Analysis of the following required documentation is necessary to verify all consumer rental income:

- a. IRS Form 1040 Schedule E; and
- b. Current leases/rental agreements.

5. *Analyzing IRS Form 1040 Schedule E.*
 - a. The IRS Form 1040 Schedule E is required to verify all rental income. Depreciation shown on Schedule E may be added back to the net income or loss.
 - b. Positive rental income is considered gross income for qualifying purposes, while negative income must be treated as a recurring liability.
 - c. The creditor must confirm that the consumer still owns each property listed, by comparing Schedule E with the real estate owned section of the Uniform Residential Loan Application (URLA).

6. *Using Current Leases To Analyze Rental Income.*
 - a. The consumer can provide a current signed lease or other rental agreement for a property that was acquired since the last income tax filing, and is not shown on Schedule E.
 - b. In order to calculate the rental income:
 - i. Reduce the gross rental amount by 25 percent for vacancies and maintenance;
 - ii. Subtract PITI and any homeowners association dues; and
 - iii. Apply the resulting amount to income, if positive, or recurring debts, if negative.

7. *Exclusion of Rental Income From Property Being Vacated by the Consumer.*

Underwriters may not consider any rental income from a consumer's principal residence that is being vacated in favor of another principal residence, except under the conditions described below:

NOTES:

 - i. This policy assures that a consumer either has sufficient income to make both mortgage payments without any rental income, or has an equity position not likely to result in defaulting on the mortgage on the property being vacated.
 - ii. This applies solely to a principal residence being vacated in favor of another principal residence. It does not apply to existing rental properties disclosed on the loan application and confirmed by tax returns (Schedule E of form IRS 1040).

8. *Policy Exceptions Regarding the Exclusion of Rental Income From a Principal Residence Being Vacated by a Consumer.*

When a consumer vacates a principal residence in favor of another principal residence, the rental income, reduced by the appropriate vacancy factor, may be considered in the underwriting analysis under the circumstances listed in the table below.

Exception	Description
Relocations	<p>The consumer is relocating with a new employer, or being transferred by the current employer to an area not within reasonable and locally-recognized commuting distance.</p> <p>A properly executed lease agreement (that is, a lease signed by the consumer and the lessee) of at least one year's duration after the loan is closed is required.</p> <p>Note: Underwriters should also obtain evidence of the security deposit and/or evidence the first month's rent was paid to the homeowner.</p>
Sufficient Equity in Vacated Property	<p>The consumer has a loan-to-value ratio of 75 percent or less, as determined either by:</p> <ul style="list-style-type: none"> • A current (no more than six months old) residential appraisal, or • Comparing the unpaid principal balance to the original sales price of the property. <p>Note: The appraisal, in addition to using forms Fannie Mae 1004/Freddie Mac 70, may be an exterior-only appraisal using form Fannie Mae/Freddie Mac 2055, and for condominium units, form Fannie Mae 1075/Freddie Mac 466.</p>

E. *Non-Taxable and Projected Income*

1. *Types of Non-Taxable Income.*

Certain types of regular income may not be subject to Federal tax. Such types of non-taxable income include:

- a. Some portion of Social Security, some Federal government employee retirement income, Railroad Retirement Benefits, and some State government retirement income;
- b. Certain types of disability and public assistance payments;
- c. Child support;
- d. Military allowances; and
- e. Other income that is documented as being exempt from Federal income taxes.

2. *Adding Non-Taxable Income to a Consumer's Gross Income.*

- a. The amount of continuing tax savings attributed to regular income not subject to Federal taxes may be added to the consumer's gross income.
- b. The percentage of non-taxable income that may be added cannot exceed the appropriate tax rate for the income amount. Additional allowances for dependents are not acceptable.
- c. The creditor:
 - i. Must document and support the amount of income grossed up for any non-taxable income source, and
 - ii. Should use the tax rate used to calculate the consumer's last year's income tax.

NOTE: If the consumer is not required to file a Federal tax return, the tax rate to use is 25 percent.

3. *Analyzing Projected Income.*

- a. Projected or hypothetical income is not acceptable for qualifying purposes. However, exceptions are permitted for income from the following sources:
 - i. Cost-of-living adjustments;
 - ii. Performance raises; and
 - iii. Bonuses.
- b. For the above exceptions to apply, the income must be:
 - i. Verified in writing by the employer; and
 - ii. Scheduled to begin within 60 days of loan closing.

4. *Projected Income for New Job.*

- a. Projected income is acceptable for qualifying purposes for a consumer scheduled to start a new job within 60 days of loan closing if there is a guaranteed, non-revocable contract for employment.
- b. The creditor must verify that the consumer will have sufficient income or cash reserves to support the mortgage payment and any other obligations between loan closing and the start of employment. Examples of this type of scenario are teachers whose contracts begin with the new school year, or physicians beginning a residency after the loan closes.
- c. The income does not qualify if the loan closes more than 60 days before the consumer starts the new job.

III. CONSUMER LIABILITIES: RECURRING OBLIGATIONS

1. *Types of Recurring Obligation. Recurring obligations include:*
 - a. All installment loans;
 - b. Revolving charge accounts;
 - c. Real estate loans;
 - d. Alimony;
 - e. Child support; and
 - f. Other continuing obligations.

2. *Debt to Income Ratio Computation for Recurring Obligations.*
 - a. The creditor must include the following when computing the debt to income ratios for recurring obligations:
 - i. Monthly housing expense; and
 - ii. Additional recurring charges extending ten months or more, such as
 - a. Payments on installment accounts;
 - b. Child support or separate maintenance payments;
 - c. Revolving accounts; and
 - d. Alimony.

b. Debts lasting less than ten months must be included if the amount of the debt affects the consumer's ability to pay the mortgage during the months immediately after loan closing, especially if the consumer will have limited or no cash assets after loan closing.

NOTE: Monthly payments on revolving or open-ended accounts, regardless of the balance, are counted as a liability for qualifying purposes even if the account appears likely to be paid off within 10 months or less.

3. *Revolving Account Monthly Payment Calculation. If the credit report shows any revolving accounts with an outstanding balance but no specific minimum monthly payment, the payment must be calculated as the greater of:*
 - a. 5 percent of the balance; or
 - b. \$10.

NOTE: If the actual monthly payment is documented from the creditor or the creditor obtains a copy of the current statement reflecting the monthly payment, that amount may be used for qualifying purposes.

4. *Reduction of Alimony Payment for Qualifying Ratio Calculation. Since there are tax consequences of alimony payments, the creditor may choose to treat the monthly alimony obligation as a reduction from the consumer's gross income when calculating the ratio, rather than treating it as a monthly obligation.*

IV. CONSUMER LIABILITIES: CONTINGENT LIABILITY

1. *Definition: Contingent Liability.* A contingent liability exists when an individual is held responsible for payment of a debt if another party, jointly or severally obligated, defaults on the payment.
2. *Application of Contingent Liability Policies.* The contingent liability policies described in this topic apply unless the consumer can provide conclusive evidence from the debt holder that there is no possibility that the debt holder will pursue debt collection against him/her should the other party default.
3. *Contingent Liability on Mortgage Assumptions.* Contingent liability must be considered when the consumer remains obligated on an outstanding FHA-insured, VA-guaranteed, or conventional mortgage secured by property that:
 - a. Has been sold or traded within the last 12 months without a release of liability, or
 - b. Is to be sold on assumption without a release of liability being obtained.
4. *Exemption From Contingent Liability Policy on Mortgage Assumptions.* When a mortgage is assumed, contingent liabilities need not be considered if the:
 - a. Originating creditor of the mortgage being underwritten obtains, from the servicer of the assumed loan, a payment history showing that the mortgage has been current during the previous 12 months, or
 - b. Value of the property, as established by an appraisal or the sales price on the HUD-1 Settlement Statement from the sale of the property, results in a loan-to-value (LTV) ratio of 75 percent or less.
5. *Contingent Liability on Cosigned Obligations.*
 - a. Contingent liability applies, and the debt must be included in the underwriting analysis, if an individual applying for a mortgage is a cosigner/co-obligor on:
 - i. A car loan;
 - ii. A student loan;
 - iii. A mortgage; or
 - iv. Any other obligation.
 - b. If the creditor obtains documented proof that the primary obligor has been making regular payments during the previous 12 months, and does not have a history of delinquent payments on the loan during that time, the payment does not have to be included in the consumer's monthly obligations.

V. CONSUMER LIABILITIES: PROJECTED OBLIGATIONS AND OBLIGATIONS NOT CONSIDERED DEBT

1. *Projected Obligations*

- a. Debt payments, such as a student loan or balloon-payment note scheduled to begin or come due within 12 months of the mortgage loan closing, must be included by the creditor as anticipated monthly obligations during the underwriting analysis.
- b. Debt payments do not have to be classified as projected obligations if the consumer provides written evidence that the debt will be deferred to a period outside the 12-month timeframe.
- c. Balloon-payment notes that come due within one year of loan closing must be considered in the underwriting analysis.

2. *Obligations Not Considered Debt*

Obligations not considered debt, and therefore not subtracted from gross income, include:

- a. Federal, State, and local taxes;
- b. Federal Insurance Contributions Act (FICA) or other retirement contributions, such as 401(k) accounts (including repayment of debt secured by these funds):
- c. Commuting costs;
- d. Union dues;
- e. Open accounts with zero balances;
- f. Automatic deductions to savings accounts;
- g. Child care; and
- h. Voluntary deductions.