At-A-Glance
Selling Guide Updates Related to the Tax Cuts and Jobs Act
The information contained in this document is not intended to be tax advice and should not be construed or relied upon as tax advice. The information is not a complete overview of the Tax Cuts and Jobs Act and does not identify every change that may result from the new tax legislation. The document contains information on certain updates to the Fannie Mae Selling Guide and Desktop Underwriter® (DU®) Validation Service as a result of some tax form revisions. This information is provided as a courtesy to lenders to summarize the Fannie Mae Selling Guide and DU Validation Service updates as a result of certain 2018 tax form revisions.
Impacts to Tax Returns and Income Reporting

Individual and business tax returns often are used to verify and calculate qualifying income. Recent tax reform legislation has resulted in changes to 2018 IRS tax forms and how certain income and expenses are reported for tax filing purposes. Some of the changes impact Selling Guide requirements, while others appear to have no impact and/or statistical data is not yet available.

The table below describes tax changes related to eligible income sources, identifies the IRS form used to report the applicable income/expense, and summarizes action taken by Fannie Mae.

<table>
<thead>
<tr>
<th>Reporting Change</th>
<th>IRS Form</th>
<th>Impact</th>
<th>Overview of Action Taken by Fannie Mae</th>
</tr>
</thead>
<tbody>
<tr>
<td>Miscellaneous itemized deductions, subject to the 2% of adjusted gross income floor, are suspended through tax year 2025.</td>
<td>1040; Schedule A Form 2106, See Exhibit A (page 5)</td>
<td>Lenders cannot identify unreimbursed employee expenses to apply related policy. B3-3.1-04, Commission Income, B3-3.1-09, Other Sources of Income; Automobile Allowance</td>
<td>Selling Guide Announcement SEL-2018-09 Dec. 4, 2018 DU Validation Service Update DU V. 10.3 Release March 29, 2019 Policy updated to remove the requirement for IRS Form 2106 and eliminate different treatment of commission income based on the percentage of employment income. All commission income is treated the same and individual tax returns (or tax transcripts) are no longer required to calculate commission income or automobile allowance. DU Validation Service updated to align with this change.</td>
</tr>
<tr>
<td>The field (line item) to report pension and annuity now includes IRA Distributions.</td>
<td>1040, See Exhibit B (page 5)</td>
<td>Tax return details are insufficient to confirm the source of income as pension or annuity (does not require evidence of continuance). The source may be an IRA distribution (does require evidence of continuance). B3-3.1-09, Other Sources of Income; Retirement, Government Annuity, and Pension Income</td>
<td>Future Selling Guide Announcement Policy update pending to eliminate individual tax returns as documentation to evidence pension or annuity income.</td>
</tr>
<tr>
<td>The field (line item) to report pension and annuity now includes retirement income previously reported under the IRA Distributions field.</td>
<td>Tax Transcript Summary, See Exhibit B (page 5)</td>
<td>Unlike pension and annuity, retirement income paid in the form of a distribution from a retirement account, i.e., a distribution from an IRA, 401(k) or Keogh retirement account, is not eligible for validation in the DU Validation Service.</td>
<td>DU Validation Service Update DU V. 10.3 Release July 20, 2019 Policy update pending to add retirement income paid in the form of a distribution from a retirement account, such as an IRA distribution, as an eligible income type for income validation in the DU Validation Service. DU messaging will be updated to inform the lender that evidence of continuance is required when retirement income is paid in the form of a distribution from a 401(k), IRA, or Keogh retirement account.</td>
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<td>Introduces Schedule 1; reports additional income and adjustments to income</td>
<td>1040; Schedule 1 See Exhibit C (page 6)</td>
<td>Does not include a reference to Schedule 1</td>
<td>Selling Guide Announcement SEL-2019-05 June 5, 2019</td>
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<tr>
<td>Entertainment expense is no longer included in Part II: Expenses</td>
<td>1040; Schedule C See Exhibit D (page 6)</td>
<td>Form 1084, Cash Flow Analysis includes a reference to entertainment expense.</td>
<td>Selling Guide Announcement SEL-2019-05 June 5, 2019</td>
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<td>For certain taxpayers, an alimony obligation is no longer reported as an adjustment to income.</td>
<td>1040; Schedule 1</td>
<td>No pending update to B3-6-05, Monthly Debt Obligations</td>
<td>A copy of the divorce decree, separation agreement, court order, or equivalent documentation verifies the alimony obligation (a tax return is not required). The option to reduce qualifying income by the amount of the alimony obligation, in lieu of including it as a monthly payment, does not require evidence income is adjusted downward for tax filing purposes. This option remains eligible because it calculates the amount of income that is legally available to the borrower.</td>
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<td>For certain taxpayers, alimony is no longer reported as income for tax filing purposes.</td>
<td>1040; Schedule 1</td>
<td>No pending update to B3-3-1-09, Other Sources of Income B3-3-1-01, General Income Information</td>
<td>A tax return is not required to evidence Alimony income. Policy that permits the lender to use non-taxable income to adjust the borrower's gross income applies to non-taxable income sources without exclusion.</td>
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<td>A new provision allows a deduction of up to 20% of qualified business income for owners of some businesses.</td>
<td>1040, Page 2 See Exhibit E (page 7)</td>
<td>No pending update to B3-3-2-01 Self-Employment Income</td>
<td>Fannie Mae Form 1084, Cash Flow Analysis uses income details provided on Schedule K-1 and business tax returns. As a result, the newly introduced qualified business income deduction (reported on IRS Form 1040) does not impact the calculation of self-employment income.</td>
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Exhibit A – IRS Form 1040; Schedule A

Miscellaneous deductions, including unreimbursed employee expenses (certain professions are exempt), are temporarily suspended and no longer reported on Schedule A.

Exhibit B – IRS Form 1040; Page 1 & Schedule 1

IRS Distributions are combined with Pension and Annuities and moved from page 1 to page 2 with resulting change in line item numbering.

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Exhibit C – IRS Form 1040; Page 1 & Schedule 1

Adjustments to income historically reported on page 1 are now itemized on Schedule 1 and the aggregate total reported on page 2.

Exhibit D – IRS Form 1040; Schedule C

Entertainment expense is no longer reported.

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Exhibit E – IRS Form 1040; Page 2

IRS Distributions are combined with Pension and Annuities and moved from page 1 to page 2 with resulting change in line item numbering.

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Effective with 2018 reporting of income on federal tax returns, there are changes in the structure and reporting of recurring income from a borrower’s current employer. For example, commissions historically reported to the borrower on IRS Form W2 are being reported to the borrower on IRS Form 1099.

Q1: The borrower’s compensation structure has been altered to benefit from tax reform legislation. How does this impact income eligibility and documentation requirements?

A: The lender can follow standard policy and consider the borrower’s tenure and earnings history with the current employer when applying relevant policy.

Income Type

Apply eligibility standards and documentation requirements according to how the income is reported for tax filing purposes. For example,

- If the borrower reports the income using IRS Form 1040; Schedule C, follow self-employment income policy.
- If the borrower reports the income as individual income on Form 1040, apply policy specific to the income type (e.g., commission income, other sources of income).

Minimum Length of History

A two-year history is generally required for certain income types (e.g., self-employment income and commission income); however, policy allows the lender to consider a shorter history – 12 to 24 months, for example – when certain conditions are met:

- The borrower’s most recent signed federal income tax return reflects the receipt of such income at the same (or greater) level in a field that provides the same products or services (Selling Guide B3-3.2-01, Underwriting Factors and Documentation for a Self-Employed Borrower), or
- There are positive factors to reasonably offset the shorter income history (Selling Guide B3-3.1-04, Commission Income).

Income Calculation

When calculating income for qualifying purposes, lenders should follow the method applicable to how the income is reported for federal tax filing purposes (e.g., self-employment income, commission income).

Q2: Tax reform legislation impacts how 2018 income is reported for federal tax filing purposes. For example, in most cases, entertainment expense is no longer an eligible business expense deduction. Do I need to change how self-employment income is calculated to account for historical business expenses that are no longer deductible?

A: Yes, lenders may continue to add back the amount of the depreciation deduction a self-employed borrower reports on Schedule C. This includes vehicle depreciation included as part of the standard mileage deductions.

Self-employment Income Documentation

Policy permits the lender to waive business tax returns when certain requirements are met, including but not limited to:

- The borrower’s individual tax returns show an increase in self-employment income during the past two years (Selling Guide B3-3.2-01, Underwriting Factors and Documentation for a Self-Employed Borrower)

When reviewing the borrower’s individual tax returns for the purpose above, lenders are not required to:

- Adjust business cash flow to consider expense deductions reported in a prior year that are not available in the most recent year, or
- Reduce self-employment income by the amount of the Qualified Business deduction.

Q3: Similar to unreimbursed employee expenses, which no longer must be deducted from commission income, can lenders also disregard prior year entertainment expense when adjusting business cash flow since this expense will also no longer be reported?

A: No, lenders aren’t required to deduct unreimbursed employee expenses when evaluating commission income and/or automobile allowance because tax returns are no longer required to verify this income. When tax returns are required to verify income (e.g., self-employment income), the lender must follow standard practices, which include an adjustment to business cash flow when nondeductible expenses are reported.

Q4: With the update to automobile allowance policy, can lenders continue to add back vehicle depreciation when reported by the borrower?

A: Yes, lenders may continue to add back vehicle depreciation when reported by the borrower on Schedule C. This includes vehicle depreciation included as part of the standard mileage deductions.

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