

Self-Employment in CCDF

The U.S. Department of Labor reports that over 14 million people in the United States are self-employed, representing nearly ten percent of the labor forceⁱ. Developing eligibility policies to address self-employment is challenging due to the complex business structures and difficulty of obtaining verification of income and the need for care. NCCCSIA researched IRS income tax guidelines and self-employment policies of 46 States and Territories. This paper discusses the key findings and identifies important issues for Lead Agencies to consider when developing their policies.

What is Self-employment?

The IRS defines self-employment as a trade or business activity carried on for a livelihood in good faith to make a profit.ⁱⁱ A person is considered self-employed if the individual carries on a trade or business as a sole proprietor or independent contractor, is a member of a partnership, or is otherwise in business for him or herself.ⁱⁱⁱ The business does not need to be profitable every year, but there must be a clear profit motive and the owner must demonstrate consistent efforts to increase business income.

Most Lead Agencies do not address these types of business structures in their eligibility policies. The most common include sole proprietorships, partnerships, corporations, S corporations, and limited liability companies (LLCs). Nearly two-thirds of all self-employment enterprises are sole proprietorships owned and operated by one person or a married couple.

Lead Agencies should be aware of the different business structures for income verification and calculation purposes. For example, owners of incorporated businesses that also work for the business are employees of the corporation. They receive salaries and report the earnings on their personal income tax returns. The corporation files a separate tax return, which includes details of any profits retained or distributed to the owners.

Does Self-employment Qualify as an Approved Work Activity?

A core objective of CCDF is to assist families in becoming economically self-sufficient. Lead Agencies have broad flexibility to determine the types of job activities to support. Whether a person is engaged in a qualified self-employment activity is not always clear.

A Business versus a hobby or pastime. Eligibility caseworkers must determine if a parent reporting self-employment is engaged in a qualifying work activity. The IRS developed examples of questions that serve as guidelines for determining if an individual is self-employed:

- Does the time and effort put into the activity indicate a good faith intention to make a profit?
- Does the business advertise and offer services to the public?
- Does the person have the knowledge and resources needed to carry on a successful business?
- Does the family depend on income from the activity?
- Has the activity made a profit in some years?
- Has the owner made efforts to improve profitability?

The following is an example of how Connecticut used IRS guidance to develop a working definition of self-employment:

Self-employment is defined as being directly engaged in an income producing trade or business started and carried on in good faith for the purpose of making a living and presented to the general public as being engaged in selling goods and/or services regularly with repetition and continuity of operation as one's occupation.

Minimum wage. Twenty-seven (27) Lead Agencies use the state or federal minimum wage to determine if self-employment is an allowable activity, and/or the number hours of care to authorize:

- Divide the gross or net self-employment income by the minimum wage. The result is the number of care hours the program will support. Some States impose a threshold on the minimum number of hours needed to qualify for assistance; for example, the net income divided by the minimum wage must equal at least 20 hours.
- Divide the gross or net self-employment income by the number of hours the parent reports working. If the result is less than the minimum wage, the Lead Agency may not support the activity.
- Multiply the minimum wage by the number of hours the child is in care each week. If the result is less than the weekly self-employment income, the Lead Agency may not support the activity.

Some States grant a one-time exemption from the minimum wage requirement to allow parents sufficient time to increase earnings to acceptable levels. Lead Agencies may want to consider:

- Whether parents with new self-employed businesses, who may not yet be receiving regular income, should be subject to the minimum wage requirements.
- Whether to use actual care hours needed, or the minimum number of weekly care hours allowed in minimum wage calculations.
- Whether to base the amount of care authorized on the result of minimum wage calculations, or based on the parent's needs and schedules.
- How to determine care hours for parents with flexible or varying schedules.

Computing Income and Deductions

Lead Agencies generally use net income to determine eligibility for self-employed families by subtracting allowable expenses and deductions from the gross business earnings. The three most common methods States use to determine net income, include:

- A standard percent deduction established by the Lead Agency (3 States)
- Itemized deductions, either those allowed by the IRS, or the Lead Agency's own list of allowable deductions — often excluding deductions for depreciation, the purchase of durable goods, prior year business losses, and state and local taxes (34 States)
- The choice of either a standard percent deduction or itemized deductions as determined by the family (6 States)

Standard percent deductions utilized by Lead Agencies generally range from 20 percent to 50 percent of the gross business earnings. When there is a choice between the two methods, families usually must document that the itemized expenses exceed the standard deduction. Regardless of the income calculation method, accuracy largely depends on obtaining complete and reliable documentation.

National statistics of IRS tax filings show extreme variations between the gross and net income for the different business structures and types of services provided. For example, the net incomes of incorporated businesses range from 3% to 70% of gross earnings^{iv}. Due to this extreme variance, Lead

Agencies may want to consider establishing separate standard deduction rates based on the business structure and type of business activity^v.

Lead Agencies may wish to coordinate income calculation policies with other assistance programs. The Supplemental Nutrition Assistance Program (SNAP) provides considerable guidance on self-employment income and deductions^{vi}. Medicaid and State Children's Health Insurance Programs (SCHIP) are other viable options.

Verification and Documentation

Documenting Self-Employment. Most Lead Agencies expect self-employed individuals parents to comply with State and Federal labor and tax laws. Self-employed parents must present sufficient documentation to establish the presence of a qualifying business activity, income, and the need for care. Common sources of verification include:

- Annual or quarterly tax statements (actual schedules and attachments will vary depending on business structure)
- Personal income tax returns and tax form schedules
- Corporation and partnership tax returns
- Business records, such as ledgers, receipts, and contracts
- Records from a bookkeeper or accountant
- Business registrations and licenses

New businesses and alternative documentation. Because new business owners will likely not have all required documentation available, Lead Agencies should establish verification standards for new self-employment activities. Options include:

- Require families to submit personal records of work already performed, gross and net earnings, and documentation of scheduled work activities.
- Allow parents to estimate income and child care needs until sufficient documentation becomes available. Some States developed self-employment worksheets for this purpose.
- Accept written statements from parents, customers or reliable third party sources as documentation that the activity is taking place.
- Requiring parents to submit three or more months of business records before eligibility can be determined. Therefore, the self-employment activity must be at least three months old.

Third party sources. Using third party verification can help confirm information provided by parents and improve program integrity. Examples of sources Lead Agencies use include:

- State department of labor and unemployment wage records
- Motor vehicle records for vehicles registered to the applicant, business, or home address
- In-state and out-of-state real estate records
- State business registrations
- Credit reports
- Internet searches of the business and business owner

Special Circumstances

Home-based work. Most Lead Agencies have rules regarding self-employment activities carried out in the home. Some do not consider home-based self-employment a qualifying activity. Five States have specific conditions that must be met before support is provided. Factors to consider include:

- The number of hours and flexibility of the work schedule
- Whether the family is a two-parent household
- If the parent serves customers in the home
- The use of equipment that may endanger a child
- The child's age and needs

Rental properties. A passive rental activity is one in which the owner receives payment for the use of the property rather than compensation for services performed. The IRS generally considers rental activities passive unless the owner materially participates in the management of each property for at least 500 hours per year. Several Lead Agencies have implemented similar rules for rental property owners. Lead Agencies will need to decide whether to allow for depreciation and other itemized deductions that may be unique to rental property owners.

Attachments

- Example self-employment definitions
- State policy table

ⁱ Bureau of Labor Statistics, United States Department of Labor. *The Employment Situation*.

<http://www.bls.gov/news.release/empsit.toc.htm>

ⁱⁱ IRS FS-2008-23, June 2008: <http://www.irs.gov/uac/Is-Your-Hobby-a-For-Profit-Endeavor%3F>

ⁱⁱⁱ Internal Revenue Service, United States Department of the Treasury. *Self-Employed Individuals Tax Center*.

<http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Self-Employed-Individuals-Tax-Center>

^{iv} National statistics on net business income are located on the IRS website at <http://irs.gov/uac/Tax-Stats-2>.

^v In addition, the CCDBG Act of 2014 requires States to demonstrate how its processes for initial determination and redetermination of eligibility take into account irregular fluctuations in income. (*Section 658E(c)(2)(N)(i)(II)*)

^{vi} Refer to 7 CFR §273.9 for details. <http://www.gpo.gov/fdsys/pkg/CFR-2011-title7-vol4/pdf/CFR-2011-title7-vol4-sec273-9.pdf>