NON-TANF CHILD CARE ELIGIBILITY

CHILD CARE 2 – 4a

Household income – Self-Employment

Supersedes: Child Care 2-4 (2/1/11)

References: 45 CFR 98.20; 52-2-701 - 704; 52-2-713 MCA
ARM 37.80.201 - 202

General Rule

Self-employment is earning one's livelihood directly from one's own trade or business rather than as an employee of another. To be self-employed, an individual is normally highly skilled in a trade or has a niche, product or service for his or her local community.

Employee or Self-Employed?

An individual is not self-employed if performing services that can be controlled by an employer. If an employer-employee relationship exists (no matter what the relationship is called), the individual is not self-employed. The source of the income and the individual's involvement in the activity from which the income is generated will determine whether it is self-employment income.

Self-Employment Verification

Written verification of self-employment status must be submitted at the time of application. For applicants who claim to be self-employed, the Child Care Resource and Referral (CCR&R) Specialist must verify their self-employment status. This can be done through several types of documentation. The applicant may possess a business license issued by the city or state or have a Federal Employer Identification Number [FEIN] issued by the Internal Revenue Service or some other verification from the Internal Revenue Service [IRS] that they are self-employed or both.

Regardless of whether they possess a business license, self-employed persons must file specific tax forms with the IRS. The IRS requires that self-employed persons file Schedule C, Profit or Loss from business. Some self-employed persons may be able to file Schedule C-EZ if their business had gross receipts of under $25,000 and expenses of $2,000 or less and they had no employees. If the applicant filed either of these forms for the previous year, copies would document the self-employment status of the applicant.

The IRS also requires that persons with $400 of net earnings file a Schedule SE, Self-Employment Tax. This form would show the amount of self-employment tax paid for the previous year. In addition, some persons are required to estimate and pay their tax liability in advance. This is done on Form 1040-ES, Estimated Tax for Individuals. If a self-employed person calculates and pays estimated taxes on self-employment earnings, that would verify their self-employment status.

Tax returns must show all schedules, tax preparer signature and date complete to be considered. Stand-alone Schedule Cs [Profit and Loss] statements are not allowable without the filed tax return it was included with.

Earned Income

The term earned income for the self-employed individual encompasses all income derived from activities in which he/she is engaged as a self-employed individual. Earned income is measured as gross earned income before any deductions that the individual receives. Net taxable income of a self-employed person is reported on Schedule C of IRS Form 1040. Self-employment income may be generated by freelance work, royalties, consulting, or income from sole proprietorship businesses. Social Security taxes must be paid on self-employment income. An individual receiving self-employed income may either pay taxes during the taxable year or make a lump sum payment with their tax return on April 15 of each year.

Verifying Earned Income

It is the applicant's responsibility to provide verification of his/her earned income. The applicant's income and work schedule shall be provided to the Child Care Resource and Referral [CCR&R] on the form. In addition, Child Care Resource and Referral [CCR&R] eligibility specialists may corroborate the applicant's statement using the following information:

- Business records such as ledgers, receipts, and contracts;
- Income tax returns - state/federal – must show proof of filing;
- Receipts for work-related expenses [Sole proprietorship, Partnership, S-corporation];
- Sales/services receipts;
- State Department of Revenue;
- W-2 forms [as may apply to employees] or 941 forms;
- Proof of payroll payments or draws from the business checking/savings account; and/or
- Records from a bookkeeper or accountant that is not employed by the applicant.

An applicant/participant may self-certify that he/she had no self-employment earnings or a negative income during the relevant months; however, those with no income or negative income are not eligible for child care assistance.

Self-Employment Structures

While there are many types of self-employment structures, some of the more common structures typically include the following:

- Sole Proprietorship is a self-employed business that is not incorporated and has one owner. The business income and liabilities are the responsibility of a single owner.
- Partnership is a self-employed business that is set up with two or more partners. In addition to personal income tax forms, partnerships are also required to file 1065 and K-1 forms. The business income and liabilities are the responsibility of all the partners with the partnership defining shares of ownership and responsibility. Partnership income is determined in the same way as other self-employment.
- Independent Contractor is an individual who pays their own employment taxes and does not have an employee/employer relationship.

Corporations

Corporations are business entities in which the corporation receives the profits. The income individuals receive from the corporation is not considered self-employment income. Individuals working for corporations are considered employees and monies received are consider wages/earned income. Wages paid to corporate officers are considered earned income. Fees paid to corporate directors are considered self-employment earnings.

Any corporate income reported on Schedule E, Line 31 as income received from a corporation must be annualized and used as countable unearned income even if the household did not receive the money. Any loss reported on Schedule E, Line 32 as loss received from a corporation is NOT used in any budget calculation.

Limited liability companies [LLCs] and limited partnerships are treated like corporations for eligibility purposes, regardless of what tax documents may be filed with the IRS. Income other than “guaranteed salaries” received from a limited liability company or partnership is unearned income.

Unearned Income

Unearned Income means an individual's income derived from sources other than employment, such as interest and dividends from investments, or income from rental property. It is the applicant or participant’s responsibility to provide verification of this type of income.

Verifying Unearned Income

It is the applicant’s responsibility to provide verification of his/her unearned income to the Child Care Resource and Referral [CCR&R] on the *Self-Employment Verification* form. See Policy Section 2-4 for a list of unearned income sources.

New Self-employment Business

If the self-employment is new and not reflected on a previous income tax return, the applicant shall be required to submit business records [bank statements, income contracts, allowable expense receipts] from prior months showing income and expenses. Income will be prospected from these records until an income tax return reflecting the self-employment is available.

If self-employment is too new for business records, a statement of ***estimated*** income and expenses must be submitted with the scholarship application. Eligibility will be determined for no more than a 3-month period to allow actual income and expense receipts to be gathered.

Determining Self-Employment Income

Once self-employment status has been verified, the self-employed person must prove that [s]he is earning a positive net income [income minus allowable expenses]. Reviewing bookkeeping records, an auditor’s report, or a balance sheet can do this. Regardless of the information reviewed, self-employed persons must maintain an average income that exceeds their business expenses [positive net income] to remain eligible. Net income means income that exceeds expenses regardless of the amount.

See section 2-5 to convert net income to a monthly figure. The second section of Table 1 will most frequently be used to convert self-employment net income to a monthly figure.

If child care is provided for employment activity, then the net income from self-employment divided by the number of child care hours must equal the current Federal Minimum Wage to remain eligible for child care assistance. The current Federal Minimum Wage can be located at:

https://www.dol.gov/general/topic/wages. Self-Employed applicants at the time of application may choose one of three expense options: 1)35% of their gross income for expenses, 2) actual expenses as indicated on the Self-Employment Income Verification Form, or 3) no expenses. Only one option may be selected with the application. If option one [1] is selected by the applicant and they are determined to be ineligible, the applicant may request to submit expense receipts instead. If applicants select option two [2] or [3] and are found ineligible, they may not then request option one.

Self-employment status can be verified with copies of federal tax forms for self-employed persons. The dollar amount of gross self-employment income is determined by using as many sources as necessary to determine gross income and expenses, such as the following:

- Tax returns or business records which cover the relevant period;
- Applicant/Participant's statement of estimated earnings;
- Receipts for business expenses;
- Receipts of income goods and services provided [signature of the person receiving the goods and services must be affixed to the receipts]; and
- A signed statement from the bank.

Any misrepresentation of IRS tax return information may result in loss of eligibility and an overpayment. See Policy Section 6-9

If both parents in the household are self-employed, income is combined, expenses subtracted, and net income divided by the number of child care hours to equal the Federal Minimum Wage as outlined above.

Allowable Business Expense

Allowable business expenses are subtracted from the gross receipts to determine taxable gross income. Most costs of doing business are allowable expenses and may be accepted as listed on the income tax form with few exceptions. Self-employment income for Best Beginnings Scholarship purposes is computed the same as it is for the Internal Revenue Service. IRS forms are used only for verification purposes. Expenses must be current, not due from a previous fiscal period, and are allowed when they are billed or otherwise come due. Allowable expenses must directly relate to the production of income. If an expense is incurred for the business and for personal purposes, it must be divided according to principles outlined by the IRS. Receipts must be attached.

Expenses Not Allowed

The following expenses are not allowable as a deduction when determining eligibility:

- Expenses derived from capital investments:
  - Depreciation (generally derived from equipment, buildings, and building improvements);
  - Schedule 179 Expense Deduction [generally equipment];
  - Amortization [generally derived from land, business start-up costs, organizational costs for partnership or corporation];
  - Non-Sufficient Fund charges
  - Depletion (generally derived from mineral property or
  - Standing timber);

  - o Business Start-up Costs - The cost of starting a business is not allowed as an expense for eligibility purposes. The IRS considers start-up costs a capital expense and allows the business to amortize the expense over a period; and
- ❑ Payments on the principal portion of loan payments used to purchase capital assets or durable goods. [The interest portion of the loan is an allowable expense.]
- ❑ Personal expenses should not be claimed as business expenses:
  - o Personal business and entertainment expenses and
  - o Personal transportation.

A business typically has many different kinds of costs during the year. Some of these costs are counted as part of the investment in the business. They must be "capitalized," and are not allowable business expenses, and are known as **capital expenditures or capital expenses.** Generally, three kinds of costs must be capitalized:

1) **Going into business**. The costs of getting started in a business before beginning business operations are all capital expenses. This may include the cost of such things as advertising, travel, utilities, repairs, and employees' wages. These are often the same kind of expenses that could be deducted if they occur after the business is opened.
2) **Business assets.** The cost of any asset that will be used in the business for more than one year is a capital expense. There are many different kinds of business assets - for example, land, buildings, machinery, trucks, books, computer and accounting systems, furniture, patents, and franchise rights.
3) **Improvements.** The costs of making improvements to a business asset are also a capital expense, if the improvements add to the value of the asset, appreciably lengthen the time it can be used, or adapt it to a different use. However, **normal repair costs are deducted as business expenses** and not capitalized. Examples of improvements are:
   - ❑ new electric wiring;
   - ❑ a new roof;
   - ❑ new floor;
   - ❑ new plumbing;
   - ❑ bricking up windows to strengthen a wall;
   - ❑ lighting improvements;
   - ❑ abatement of hazardous substances such as asbestos.

Business motor vehicles: The cost of a motor vehicle purchased to use in the business [vehicle title must be in the business name] is usually capitalized. Its cost can be recovered through annual deductions for depreciation. Depreciation is **NOT** an allowable business expense under program policy.

> NOTE: Repairs made to the business vehicle are allowable expenses. However, amounts paid for reconditioning and overhaul of business vehicles are capital expenses.

Roads and driveways: The cost of building a private road on the business property and the cost of replacing a gravel driveway with a concrete one are capital expenses which may be able to depreciate. **The cost of maintaining a private road on the business property is allowable as an ordinary and necessary business expense.**

Tools: Amounts spent for tools used in the business are deductible expenses if the tools wear out and are thrown away within one year from the date of purchase.

Machinery: The cost of replacing short-lived parts of a machine to keep it in good working condition and not to add to its life is **allowable as an ordinary and necessary expense.**

Heating equipment: The cost of changing from one heating system to another is a capital expense and not a deductible expense.

Other Expenses

Business Employees: In order to deduct wages paid for employees of the business, payroll records showing employee name, gross wages, taxes deducted, and net wages must be provided in addition to a record showing the employee's signature to receive a check or cash for wages paid.

Gasoline Expense: For business owned vehicles [title is in the name of the business], 100% of this expense is allowable if odometer and mileage records are kept and are accompanied by fuel receipts. For a personal vehicle used for business, expenses are allowed **ONLY** if odometer and mileage records are kept and accompanied by fuel receipts.

If the Child Care Resource and Referral [CCR&R] eligibility specialist is using filed tax returns and this expense is a part of the return, mileage records and receipts will only be required at subsequent recertification or with the next filed tax returns. Tax returns must show all schedules, tax preparer signature and date complete to be considered. Although stand alone Schedule Cs [Profit and Loss] statements are not allowable without the filed tax return it was included with, the CCR&R eligibility staff may review a non-filed Schedule C if used to provide income and expenses because the self-employment business is **NEW**. In some businesses [logging, farming, construction, etc.] gas receipts may exceed mileage/odometers readings. These must be considered on a case-by-case basis.

Credit Card Expense: If the card is in the business name, a copy of the monthly bill accompanied by receipts for purchases showing the items paid for by the business card are allowable. If the card is in the name of the self-employed person, the allowable expense is proportional to usage as defined by the IRS and the accompanying receipts must provide enough information to discern that items purchased were for business use. Interest charged and late fees to cards for balances carried forward are **NOT** allowable.

Use of Family Residence: If the home is used in the business, expenses can be deducted only for that part of the home that is **used both regularly and exclusively** for the business. Applicant/participant must use IRS guidelines to determine division of use.

See Policy Section 2-5 for the method to use in converting the income into a monthly figure.