



The Self-Employment Tax Initiative

Empowering Entrepreneurs at Tax Time

*Understanding the Value of Microenterprise
& Lifting Up Innovative Models for Serving
Their Needs through Tax Assistance*

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Introduction

Small businesses provide economic security and stability for millions of American families. Creating and owning a business has long been heralded as the path to financial success and self-fulfillment in the United States, and for some, creating one's own job – self-employment – is the best possible source of employment and income. In a nation clamoring for jobs, promoting and formalizing small startup businesses provides a viable solution. Addressing the needs of these small startup businesses, particularly those whose owners are low- to moderate-income Americans, can generate profound economic and social benefits.

Because nearly every business startup must pay business-related taxes, this makes the tax preparation process a built-in, structured opportunity to reach out to startup businesses, provide free or affordable tax assistance and provide them with greater access to those same business development and asset-building services. Providing free or affordable business tax preparation services to low- to moderate-income self-employed individuals builds businesses and promotes asset building for low-income households. By paying an affordable fee, or no fee at all, to have their business taxes prepared by trained preparers, self-employed individuals can save money and ensure that they access all the tax credits for which they are eligible. Unlike other microenterprise development programs, the Self-Employment Tax Initiative (SETI) focuses on the tax code and the annual tax preparation process as the primary outreach mechanism for startup businesses.

SETI is a small business development strategy that takes advantage of the tax code to help low-income, self-employed individuals formalize and **grow** their businesses, **create jobs** and **access** tax-based asset-building opportunities. SETI recognizes the tax season as an incredibly opportune time to introduce self-employed business owners to a host of products and services that support small business development and asset building. The SETI team offers the following resources and services:

- **SETI supports field work** through sub-granting to community-based organizations that offer free or affordable tax preparation assistance to low-income, self-employed individuals. To date, SETI has partnered with 41 organizations across the country, awarding over \$500,000 in grants. These local partners help SETI identify, test and refine promising practices for using the tax filing process as a means of fostering small business development.
- **SETI conducts research and facilitates field-building** among our local partners to identify optimal ways to serve self-employed people. SETI collects and disseminates lessons learned from local partners that explore **sector-specific** strategies for business support,

outreach and delivery strategies that promote access by underserved populations, and strategies for serving entrepreneurs **beyond the tax season** with asset-building and microenterprise services.

- **SETI promotes sound tax policy** as it relates to the self-employed. SETI engages with policy partners to help analyze, understand and test the boundaries of self-employment tax policies. At the national level, SETI works with the Aspen Institute, the Association for Enterprise Opportunity, the National Association for the Self-Employed, the National Community Tax Coalition and the IRS Small Business & Self-Employment Division. At the local level, our partners in both the microenterprise and the free tax preparation fields are important participants in this policy dialogue.

Taken together, these components are intended to lead to on-the-ground tax preparation insights, new strategies and products, new understandings about self-employment tax policy and the convergence of a new set of partners committed to making the tax system work better for new microentrepreneurs.

SETI has taken advantage of this complementary outreach strategy, recognizing that the tax season is an ideal time to reach a larger pool of self-employed individuals and provide them with access to products and services that will help them grow their businesses and build financial security. The self-employment tax strategy can take on many forms, depending upon the community-based organization or institution responsible for providing the service, the population served, regional characteristics and other considerations. SETI is committed to conducting research and facilitating field building among community-based organizations that provide free or low-cost tax assistance to low- and moderate-income taxpayers and connect them to other business development or asset-building services. Here and on the online [SETI Resource Bank](#),¹ we have catalogued the academic research behind the SETI strategy as well as the challenges, successes, creative techniques and lessons learned from SETI's local partners.

Research Behind Startups & Job Creation

STARTUPS AND JOB CREATION

Startups, defined as businesses less than one year old,² create 3 million new jobs in a year on average, offsetting the jobs that older firms lose and ensuring annual positive net job creation. Essentially, without startups, there would be no net job creation in the United States each year. New business entry accounts for one-third of the annual job creation rate.³ These findings, which are based on analyses of Business Dynamics Statistics,

1 http://cfed.org/programs/seti/resource_bank/

2 Tim Kane, *The Importance of Startups in Job Creation and Job Destruction*, Kauffman Foundation Research Series: Firm Formation and Economic Growth, 2010.

3 Kane, 2010.

reveal both the sheer number of new businesses entering the economy each year and their significant impact on job creation.

Other data shows that, of the millions of new unincorporated businesses reporting income for the first time in a year, most begin as sole proprietorships, are intentional businesses and may have no employees other than the owner.⁴ Despite their small size, these businesses form the basis for future economic growth. “While they represent a relatively small share of economic activity, non-employer firms are important as a gateway to becoming employer firms, providing flexible work opportunities and a path to economic prosperity.”⁵

Every subset of new businesses – incorporated and unincorporated startups and first-time filers of Schedule C – play a quiet, often overlooked role in bolstering job creation and economic growth. Intentional efforts to advance the growth of businesses in their first few years would have a large impact, as the constituency served would include the millions of businesses that research shows enter the economy each year. Interventions targeted at unincorporated startups and the self-employed are critical, as these new businesses are often left out of job creation and economic development strategies. Kauffman Foundation scholar Tim Kane argues that “states and cities with job creation policies aimed at luring larger, older employers cannot help but fail, not just because they are zero-sum, but because they are not based in realistic models of employment growth. Job growth is driven, essentially entirely, by startup firms that develop organically.”⁶

The Challenge & the Opportunity

TAX FILING AS AN OBSTACLE TO STARTUP DEVELOPMENT AND SUCCESS

Frustrated by their lack of understanding of business taxation and even bookkeeping basics, entrepreneurs are left with few options for learning about and accurately completing their tax filings as deadlines approach. They can attempt to navigate the tax code on their own or use a commercial preparer, at an estimated cost of between \$300 and \$500 per tax return. If all else fails, and when facing a cash-flow-killing tax liability, business owners may not file at all and fall into noncompliance. This is a very dangerous non-choice which leaves them vulnerable to the risk of IRS enforcement actions, compounding penalties and arrearages, and years of financial repair work.

⁴ Zoltan J. Acs, Brian Headd and Hezekiah Agwara. [The Nonemployer Start-up Puzzle](#). An Office of Advocacy Working Paper, 2009.

⁵ Acs, Headd and Agwara, 2009.

⁶ Kane, 2010, page 6.

Few Options for Tax Filing Assistance

The inaccessibility of low-cost or free tax preparation assistance and the complexity of the tax code compel many self-employed people to seek tax assistance from commercial preparers. Based on estimates supplied by local SETI tax assistance providers in 2010, commercial tax preparers charged between \$300 and \$500 per Schedule C return, and their “one-size fits all” approach to tax preparation fails to ensure that the business owner truly understands her tax liabilities. The predatory practices of some commercial preparers can increase the cost of filing a tax return – for example, some commercial preparers convince clients to take refund anticipation loans or checks with high interest rates.

“Invisible” Businesses and Tax Noncompliance

Those business owners who do not seek help from commercial tax preparers may choose not to file taxes at all. Based on IRS data, SETI estimates there are more than 4 million businesses operating in the informal economy that do not report their business income. Their non-compliance means they are not making Social Security and Medicare payments which can only deprive them and their families of full access to the country’s basic safety net of Social Security and Medicare. They cannot take advantage of tax benefits such as the refundable Earned Income Tax Credit. An entrepreneur’s access to banking services, credit and loans to grow their businesses often depends greatly on their capacity to produce a tax filing history – those who have not yet begun filing because they were intimidated or confused are at a disadvantage when seeking business financing later on. Additionally, business growth is limited for those that exist in the informal economy, meaning their job creating power is also diminished.

Tax noncompliance means that business owners live with the constant threat of IRS action and the consequences: tax arrearages, penalties and late fees, which add up to a nearly insurmountable pile of debt. This debt can sink a business or damage its prospects for future growth – some business owners may never be able to recover from it. IRS reports that sole proprietor non-filers are responsible for a total of \$15.9 billion in unreported individual income taxes. As the Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination argues in a report on the U.S. informal economy, we do not know the potential of businesses in the informal economy, their ability to generate income for low-income families, and the magnitude of their effect on local economies.⁷

The tax code and the tax filing process provide a universal entry point for new entrepreneurs to bring their businesses into the formal economy.

⁷ Edgcomb, E. and Tamra Thetford, *The Informal Economy: Making it in Rural America*, Aspen Institute, FIELD Program, 2004.

Making business tax preparation assistance more accessible, especially for those with low incomes, would encourage entrepreneurs operating in the informal economy to formalize their businesses by filing taxes. In addition to increasing tax revenue, this process could also represent a delivery system for providing assistance to new start-ups as a way to stimulate the growth of some of these businesses.

Applying this Strategy on the Ground

HISTORY AND RESULTS OF THE SELF-EMPLOYMENT TAX INITIATIVE

Exploring the SETI Strategy: 2005-2006

CFED launched the **Self-Employment Tax Initiative** in 2005, beginning the exploration of a new, high-impact approach that would use the tax code to deliver support to millions of start-up and self-employed microbusinesses annually. In its earliest years, SETI studied the largely uncharted relationship between self-employed business formation and federal and state tax systems. The impetus for this examination grew from two directions. First, at the state level, microenterprise programs and advocates were frustrated by the fact that state governments lavish tax credits on recruiting large businesses but hardly even acknowledge the job creation role of local, smaller businesses – let alone even consider tax incentives for this homegrown constituency. Second, there was a growing awareness that the self-employed were, often for serious structural reasons, left out of the asset-building policies carried out through the federal tax code.

The SETI Demonstration: 2007-2010

In 2007, CFED began the **SETI Demonstration**, providing subgrants and technical assistance to community-based tax providers with experience offering tax assistance to self-employed taxpayers. Between the 2007 and 2010 tax seasons, the SETI Demonstration funded about 15 organizations each year to provide free tax assistance to self-employed taxpayers and collected data to measure outputs related to self-employed taxpayers' characteristics and each partner's organizational details. The partners

Schedule C & C-EZ Taxpayers Served During SETI Demonstration

	2007 Tax Season	2008 Tax Season	2009 Tax Season	2010 Tax Season
Schedule C	93	2,769	5,284	2,931
Schedule C-EZ	1,247	2,845	7,612	9,652
Total	2,193	5,614	12,896	12,583
Cumulative Sum	2,193	7,807	20,703	33,286

involved helped SETI identify, test and refine best practices for using tax time to foster small business development. The SETI Demonstration came to an end with the close of the 2010 tax season; the following catalogues the number of taxpayers served across the four years of the demonstration.

The Schedule C VITA Pilot: 2011

In September 2010, SETI and the National Community Tax Coalition (NCTC) launched the Schedule C VITA Pilot, featuring 12 Volunteer Income Tax Assistance (VITA) programs with experience preparing Schedule C returns across the United States. The purpose of the Schedule C VITA Pilot is to determine the efficacy of bringing expanded parameters of Schedule C services into the suite of tax preparation offerings provided by VITA programs. Selected pilot programs file Schedule C tax forms, in addition to 1040s, for income-eligible taxpayers with self-employment income. The pilot serves as the springboard for determining the viability of bringing more robust Schedule C parameters into VITA scope. Although the pilot is designed to test the boundaries of existing VITA scope with regard to Schedule C preparation, there are still particular parameters in place to guarantee quality tax preparation which each site must follow.

Partner VITA Site	Location
Real Sense Prosperity Campaign	Jacksonville, FL
El Paso Affordable Housing Credit Union Service Organization	El Paso, TX
East Bay Asian Local Development Corporation	Oakland, CA
Rural Dynamics, Inc.	Great Falls, MT
Just Harvest Education Fund	Pittsburgh, PA
Foundation Communities	Austin, TX
KC CASH Coalition, Inc.	Kansas City, MO
Accounting Aid Society	Detroit, MI
Center for Economic Progress	Chicago, IL
AccountAbility Minnesota	St. Paul, MN
St. Mary's University	San Antonio, TX
Campaign for Working Families	Philadelphia, PA

The Schedule C VITA Pilot sites prepared a total of 5,741 Schedule C or C-EZ tax returns during the 2011 tax season. Of those self-employed filers, more than 60% filed a full Schedule C form rather than a C-EZ. More than 85% of the self-employed tax filers served at pilot sites earned less than \$30,000 in Adjusted Gross Income (AGI) in 2010. Taxpayers' AGI includes all income earned, including wages reported on a Form 1040. Of the taxpayers reporting earnings from self-employment at the participating VITA sites, nearly two thirds also earned wage income during 2010. This suggests, as we have learned from many other tax assistance providers,

that low- to moderate-income entrepreneurs are often operating businesses to help fill household income gaps. On average, 42% of the self-employed filers served at these VITA sites received tax assistance at the same sites the year before. Of those return filers, half increased their adjusted gross incomes from the year before, which suggests the capacity for business income to serve as a critical gap filler and financial security enhancer for low-income households. The most common business types receiving assistance at Schedule C Pilot sites were childcare, construction, home care and health care services, janitorial, retail, and arts and entertainment.

Lessons Learned through Innovative Practice

Since the SETI Demonstration began, we have collected tools and lessons from community-based tax assistance providers in an effort to amass a resource of best practices to be shared with the field. Many of these best practices are catalogued on the [SETI Resource Bank](#), and some of the most noteworthy ones are highlighted here, they include: two models – web-based tax assistance and mobile tax assistance units – that have been utilized to reach taxpayers in particularly rural areas of the Northwest; a model based on a partnership between a community college and microenterprise development program using student volunteers; and the fee-for-service model, in which self-employed taxpayers are charged a below-market, affordable fee for tax assistance. The first two models were captured during these organizations’ participation in the SETI Demonstration and the last two models are the result of a much deep inquiry into lessons learned during the 2011 SETI Innovation Cluster.

THE WEB-BASED TAX ASSISTANCE MODEL

Technology presents many opportunities for serving hard-to-reach populations. Practitioners can set up two sites – a tax preparation site staffed with trained tax preparers and a local site set up in communities where clients are located. With the aid of video web cameras these volunteers can help self-employed individuals at any designated community site. This model was developed to expand on the IRS’s approved Non Face-to-Face Rural VITA/TCE site policy for assisting low-income taxpayers in designated rural areas by simulating face-to-face tax preparation with the use of technology.

[AccountAbility Minnesota](#) (AAM), which provides free tax preparation and financial services to low-income taxpayers across the state, pioneered the use of web-based tax preparation to serve self-employed clients living in remote areas of Minnesota. Using laptop computers with video cameras, AAM provides remote tax site partners across the state the opportunity to start the tax preparation screening process with a self-employed tax site

Client Profile

Mary: Taxpayer at AccountAbility Minnesota Right Direction

“Being self-employed, I get scared with taxes because I don’t know if I’m doing and tracking things right. Coming to AccountAbility Minnesota each year, I’ve gotten smarter. They educate me in a way a paid tax professional never did before.”

Mary has been coming to AccountAbility Minnesota (AAM) to have her taxes prepared for the past four years. She’s self-employed, working as a graphic designer and a personal assistant. Having worked with paid tax preparers before finding AAM’s services, Mary appreciates not only the hundreds of dollars she saves on preparation but the guidance and tools that the staff and volunteers provide her – at tax time and beyond – that enable her to run her business in a smarter and more efficient way.

When Mary first began coming to AAM for tax preparation, she sat down with Tom Larson, AAM’s self-employment program coordinator, to talk about her business. Together, they walked through reporting requirements, discussed the importance of record keeping year-round, outlined Mary’s business expenses, and most importantly, identified an easy and efficient way for Mary to track her expenses. With the help of AAM’s self-employment tax organizer – a tool to help self-employed taxpayers track their business expenses – Mary can maximize the value of the tax credits she has earned when she files her taxes. These tax credits are now a valuable source of income for Mary that she reinvests in her business to keep it growing to meet her basic needs.

customer at their rural location. When screening is completed they can access AAM's expert team of Twin Cities self-employed tax preparation volunteers to complete the returns. Video conferencing technology allows rural sites that may not have the volunteer capacity to prepare more complicated self-employment returns the opportunity to offer this vital service in their communities.

AAM's video conferencing and webinar-based training is unique in that it can be replicated relatively easily by sites that have access to a computer and an internet connection and the necessary technological expertise to run the equipment. AAM staff continues to refine the process and procedures for this innovative project and will eventually develop a manual that can be shared with VITA sites regionally and nationally.

This is also a promising model for serving **clients with disabilities** and could be an effective strategy for organizations with limited staff resources seeking to partner with organizations in other communities.

- This method depends on technology and programs are encouraged to have IT staff or tech savvy volunteers at both the host site and the preparation site(s).
- This method may require a large up-front time commitment for setting up and working with clients with limited technology experience.

A MODEL FOR MOBILE TAX ASSISTANCE UNITS

Mobile units are an effective tool for practitioners serving those with mobility constraints, remote areas and communities that need a little extra incentive to get their taxes done. They are sent into communities at a specific and widely marketed time and place. The unit itself can be a truck, van or even a car. In one type of mobile unit the vehicle parks at a location and contains all the necessary materials; tax preparers would provide their services from the vehicle itself. In another type of mobile unit service the materials are transported by a vehicle to a partner location such as a church or community space that would serve as the tax preparation site.

The mobile unit model has been used by [Rural Dynamics Incorporated \(RDI\)](#), which serves many rural, remote, Native American and disabled populations in Montana. Through their Tax Help Montana program, they have offered "tax clinics" across the state of Montana. In one case, RDI took its tax preparation team to a community where a large elderly population and offered tax preparation services at a community site. In other cases, their team of highly experienced tax preparers travels to other communities, often Native American Reservations, to provide "tax clinics" used as a targeted strategy to attract self-employed filers and to

provide on-site training to partners at the rural locations. By providing on-site training to partners at the rural and Reservation tax clinics, TaxHelp Montana is able to identify what businesses are present and learn from their partners what kind of business education would be helpful in their communities. By providing immediate reassurance and being able to answer questions on the spot, RDI's has been able to make this model successful.

- When bringing tax prep to the client, equipment, tools and supplies will be needed, including laptops, printers and paper.
- Some local partners have found that the staff resources needed to implement a mobile unit are significant, compared to the number of clients served.

THE COMMUNITY COLLEGE AND MICROBUSINESS DEVELOPMENT PROGRAM PARTNERSHIP

Community colleges provide an opportunity to link tax preparation with student volunteers and the delivery of additional small business development services. StartZone, a microenterprise development initiative of Highline Community College, offers tax preparation services and links self-employed individuals to other business support opportunities. In 2011, StartZone provided free tax assistance to small business owners using volunteer preparers, primarily accounting students from the community college and a few community volunteers as well. Other partners included the Washington Community Alliance for Self Help (Washington CASH), Seattle Housing Authority and Key Bank.

This tax year, StartZone staff faced two critical challenges as they worked toward their goals of increasing volume of taxpayers served, reaching more businesses in the informal economy and engaging more self-employed filers beyond tax time with additional services. First, a very core piece of their model, seamless integration with the community college, was not fully realized. Second, StartZone staffs' marketing and outreach strategies did not produce the results they expected. StartZone is working to improve these two elements by learning from the lessons of this year and best practices in the self-employment tax preparation field around building effective strategic partnerships with a community college and conducting effective marketing and outreach.

- This model requires a strong relationship between the microenterprise development program and the community college in order to ensure that the tax program has the greatest possible access to resources from the community college, including student tax preparation volunteers and faculty support.
- Students often make great volunteers – they are usually eager and

Client Profile

Miguel: Moving in the Right Direction

The tax filing experience is a valuable teachable moment through which practitioners can help self-employed taxpayers understand their liabilities, grasp the benefits of filing taxes to formalize their businesses and access the products and services that will enable them to build household financial security through entrepreneurship.

Rebecca Pear, the Business Tax Advisor at Brooklyn Cooperative worked with Miguel, a 36-year-old carpenter and sculptor who was referred to her by a foreclosure-counseling partner. He had struggled to make the full loan payments due on his property, and had visited the foreclosure counselors for help. For various reasons, Miguel mistrusts the government and financial institutions and so he had not filed taxes or maintained his own bank account for years.

However, since mortgage institutions and foreclosure counselors require proof of finances in order to put together a loan modification application, they advised him to file his 2010 taxes and provide organized financial statements for the first three months of 2011 in order to move forward with a loan modification. After reviewing his situation, Rebecca helped Miguel file his 2010 taxes and created a first quarter Profit and Loss statement for his carpentry and sculpting business activity. Miguel realized that he needed to maintain his own bank account, so he opened a business bank account at the credit union in order to gain better control of his business income and expenses. While he still has a ways to go to get back on track with his finances, Brooklyn Cooperative is helping him to move in the right direction.

willing to learn and engage in volunteerism, particularly when it increases their marketable skills. At the same time, in spite of their enthusiasm, young students may struggle to grasp Schedule C preparation and may require much more close supervision than older, non-student volunteers from the community.

- Engaging self-employed filers beyond tax assistance is always a challenging endeavor and will require new and innovative strategies. Even though StartZone offers tax assistance services in the same location where small business development workshops and other programs are offered, convincing self-employed taxpayers to take advantage of those services requires more than simply notifying them that wrap-around support is available.

THE FEE FOR SERVICE MODEL

While low-wage and salary workers in the United States can access free tax preparation services through the IRS Volunteer Income Tax Assistance (VITA) program, self-employed businesses with expenses over \$10,000 are typically not eligible for VITA. Brooklyn Cooperative Federal Credit Union is a community development credit union that services these entrepreneurs through consumer, business and home loans and core financial services, including tax preparation services. So, rather than providing free tax assistance with rigid income restrictions, Brooklyn Cooperative charges a below-market fee and makes the program available to any independent contractor or small business owner needing help with their taxes. In doing so, Brooklyn Cooperative meets an important institutional need – organizational financial sustainability – and a critical tax preparation need for local small businesses, since many neighborhood accounting and commercial tax preparation services are prohibitively expensive and may end up severely misreporting businesses' tax liabilities, leading to large tax debts and liens. Here's what they learned:

- Many business owners actually prefer to pay a fee for tax assistance rather than to visit a free tax assistance provider. Because they are paying for a quality service at an affordable price, they expect the tax preparer to behave professionally and they behave accordingly as well.
- In contrast to many Volunteer Income Tax Assistance programs, which report a notable number of misclassified employees and unintentional entrepreneurs, the fee-for-service model attracts more intentional small business tax filers for whom their business is typically their primary source of income.

Conclusion

Job growth in the United States is driven almost entirely by business startups, and tax season is the best time to identify, reach and offer support to the 9.8 million⁸ self-employed individuals operating unincorporated startup businesses in this country. SETI focuses on the annual tax preparation process as the primary outreach mechanism for educating self-employed business owners and connecting them to other products and services that will help them grow their businesses, incomes and wealth. Nearly all small businesses must pay business taxes in the very first year of operation. This encounter with business tax preparation can be both intimidating and, consequently, a powerful teachable moment for business startups. The mandated business tax preparation moment provides an advantageous opportunity to provide *more* business services to *more* startups, and tax reforms that make filing simpler and less costly for small businesses can further enhance this universal microenterprise gateway. SETI is exploring all of this potential. We know that when brought to scale, this strategy can:

- Enable low-income households to build and maintain assets
- Grow and expand microbusinesses and create jobs
- Build a more sustainable economy

We hope that the research, strategies, models and lessons learned shared here serve as useful tools for community-based organizations, credit unions and other community institutions, national nonprofits like CFED and funders interested in implementing creative techniques for serving the job creators on the front lines of the American economy. We also recommend that readers visit the SETI [website](#) and, in particular, the [SETI Resource Bank](#), a resource designed for community organizations that recognize self-employment tax preparation as a useful strategy for helping low-income and start-up entrepreneurs formalize and grow.

⁸ Stephen F. Hipple. Bureau of Labor Statistics, [Self-employment in the United States](#), 2010.

About CFED

CFED (Corporation for Enterprise Development) expands economic opportunity by helping Americans start and grow businesses, go to college, own a home, and save for their children's and own economic futures. We identify promising ideas, test and refine them in communities to find out what works, craft policies and products to help good ideas reach scale, and develop partnerships to promote lasting change. We bring together community practice, public policy and private markets in new and effective ways to achieve greater economic impact. www.cfed.org

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