

# POLICY INNOVATION: NEW ENTREPRENEUR TAX CREDIT

*Policy innovations are new and creative approaches to addressing social issues – such as how to help disadvantaged entrepreneurs reap the benefits of formalizing their businesses – that have the potential to reach thousands or even millions of people. CFED is committed to advancing policy innovations through innovation@cfed. Visit <http://innovation.cfed.org> to learn more.*

## OVERVIEW

More than 10 million low- and moderate-income households operate self-employed businesses in the United States and file taxes as unincorporated sole proprietors annually. More than 2 million households each year start new self-employed businesses and file business taxes for the first time. Unfortunately, as a result of misinformation and confusion, every year 4 million to 6 million self-employed businesses avoid filing business taxes and instead operate informally.<sup>1</sup>

Paying taxes for the first time as a business is one of the most challenging and consequential endeavors a new business will face. Yet the failure to do so can have a huge negative impact. It traps the business in the underground economy where it can never thrive. It limits household members' access to the country's basic safety net of Social Security. And it causes the business owner to miss out on federal and state Earned Income Tax Credits and, beginning with 2009 taxes, the federal Making Work Pay Tax Credit – both of which are available to the self-employed as well as wage earners.

Government efforts to close the “tax gap” – the difference between taxes owed and taxes paid – have often focused on enforcement, including monitoring and prosecuting non-compliance. Little effort has focused on creating positive incentives for new businesses to file taxes for the first time. A state New Entrepreneur Tax Credit that targets start-up, self-employed businesses would create such a positive incentive.

## WHAT STATES CAN DO

There are many steps states can take both to support self-employed entrepreneurs and to mitigate the challenges of filing businesses taxes for the first time. For example, they can act as a clearinghouse for information on credits currently available to sole proprietors; they can develop a statewide “start your business right” campaign that targets start-up businesses; or they can encourage volunteer tax preparation sites to provide assistance to households with self-employment income. Perhaps the most important step states can take is to enact a New Entrepreneur Tax Credit that provides a refundable credit to new businesses during the first few years of operation, when they face unusual start-up costs including unexpected tax liabilities.

## ELEMENTS OF A STRONG POLICY

CFED asserts that an effective state New Entrepreneur Tax Credit for self-employed start-ups should have the following features:

- **The credit should be available to sole proprietors.** By default, most entrepreneurs start their businesses as unincorporated sole proprietors. Unfortunately, most business tax credits are designed for more mature incorporated businesses. An effective New Entrepreneur Tax Credit must be available to sole proprietors.
- **The credit should be accessible by start-up and low-income businesses.** In most states, it takes a savvy business owner to take advantage of business tax credits. Because the total amount available

for a tax credit is often capped (for state budgetary reasons), there is a race to claim the credit. This race is usually won by more established businesses that know the rules of the game. States can mitigate this bias against start-up businesses by enacting a tax credit that is smaller in value,<sup>2</sup> but available to all qualifying start-up entrepreneurs.<sup>3</sup> Alternately, states could choose to explicitly target the credit to start-up and/or low-income entrepreneurs, rather than all entrepreneurs.

In either case, a New Entrepreneur Tax Credit also should include outreach and technical assistance to start-up businesses on how to claim the credit. Further, the process for determining eligibility for the credit should be automatic and built into the tax preparation process.

- **The revenue department should report on demographics of those who claim the credit.** The state revenue department should be required to devise methods for tracking and annually reporting to the legislature the county location, type and size of businesses accessing the tax credit. Doing so will provide data on whether disadvantaged businesses are taking advantage of the credit.
- **The credit should be simple to administer.** Conventional business tax credits are often designed to recruit and retain a few large businesses in the state. The administration of these credits is supported by multi-page applications that are managed by professional staff at the state's revenue department. By contrast, a New Entrepreneur Tax Credit should be designed to deliver smaller credits to a much broader set of start-up businesses. To manage such a tax credit, it needs to be as self-administering as possible. It could, for example, rely on information from federal tax forms, including the Sole Proprietor tax form, Schedule C.<sup>4</sup>

## WHAT STATES HAVE DONE

While states have long been generous with tax credits to recruit large businesses, they have generally ignored credits for smaller unincorporated businesses. Nebraska is one exception that provides dedicated tax credits to support microbusinesses. The Nebraska Advantage Microenterprise Tax Credit Act<sup>5</sup> provides a \$10,000 lifetime tax credit to microbusiness owners located in distressed geographic areas that make a "new investment or employment in the microbusiness." Total funding for the credit is capped at \$2 million annually. In 2007, 253 businesses, out of 408 that applied, received the tax credit.<sup>6</sup> Seventy-six percent of business that received the credit were in the agricultural industry; only 2% were in the service industry. Eighty-one percent of qualifying investments were buildings or other fixed assets.

Nebraska's law is promising; however, amendments are needed to increase its efficacy. The number of businesses served is currently small, the race to claim the credit is real and service businesses with few fixed assets may have a hard time qualifying.

<sup>1</sup> Based on CFED estimates.

<sup>2</sup> The amount of the credit should be capped at an amount (e.g., \$3,000) that is high enough to be meaningful for a low-income entrepreneur, but low enough so that it does not encourage entrepreneurs who are not "genuinely" low-income to reduce their income in order to avail themselves of the credit.

<sup>3</sup> The budget impact of structuring a tax credit in this manner could be calculated in advance in the same way that a state budgets for a state Earned Income Tax Credit (EITC).

<sup>4</sup> A successful model for this system is a state earned income tax credit. State EITCs are automatically delivered to every eligible taxpayer through the taxpayer's federal Form 1040, including the Sole Proprietor tax form, Schedule C.

<sup>5</sup> *Nebraska Revised Statutes 77-5902*, Nebraska Legislature, retrieved from <http://uniweb.legislature.ne.gov/laws/statutes.php?statute=s7759002000>.

<sup>6</sup> *Nebraska Advantage Microenterprise Tax Credit Act Report*, retrieved April 14, 2009 from [www.revenue.ne.gov/news\\_rel/mar\\_09/microbusiness\\_031209.htm](http://www.revenue.ne.gov/news_rel/mar_09/microbusiness_031209.htm).

For more information, visit CFED's Self-Employment Tax Initiative at [www.cfed.org/go/seti](http://www.cfed.org/go/seti).

For more on the 2009-2010 Assets & Opportunity Scorecard – CFED's signature research on wealth, poverty and the financial security of American families – visit <http://scorecard.cfed.org>.