State of California—Health and Human Services Agency
Department of Health Services

California Department of Health Services

DIANA M. BONTÁ, R.N., Dr. P.H.
Director

GRAY DAVIS
Governor

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MEDI-CAL ELIGIBILITY PROCEDURES MANUAL LETTER No.: 279

TO: ALL HOLDERS OF THE MEDI-CAL ELIGIBILITY PROCEDURES MANUAL

SUBJECT: ARTICLE 10 REVISIONS, INCOME ELIGIBILITY

Enclosed are revisions to Article 10, Income Eligibility, of the Medi-Cal Eligibility Procedures Manual.

Procedure Revision	**Description**
Article 10	Revision and update (see highlights) of procedures for determining and computing net income from self-employment.

Filing Instructions:

Remove Pages	**Insert Pages**
Article 10M-1 through 10M-6	Article 10M-1 through 10M7

If you have questions concerning a specific revision, please contact Mr. Dave Rappolee of my staff at (916) 657-0163.

Original signed by

Beth Fife, Chief
Medi-Cal Eligibility Branch

Enclosure

10M – DETERMINING NET INCOME FROM SELF-EMPLOYMENT

A. GUIDELINES FOR DETERMINING WHETHER AN INDIVIDUAL IS SELF-EMPLOYED

This section purposes to provide counties with assistance in determining whether an individual is self-employed for purposes of determining their income eligibility for the Medically Needy and Section 1931 programs. While generally it is clear whether an individual is self-employed, there are occasional instances where it can be difficult to determine whether the individual is self-employed or working for another. For example, an individual may be working at a "job" that has characteristics of both self-employment and being in another's employ, such as certain real estate agents or consultants. Counties must exercise their judgment in these matters. To assist counties in making this judgment, several "indicators" of self-employment are listed below.

INDICATORS OF SELF-EMPLOYMENT

- The individual defines for himself the scope and nature of his work and daily work activities, including work-duration; and such activities are not supervised or determined by another (except pursuant to a limited term, contractual arrangement*).

- Others assume no, or only limited liability, for the individual's work and for the individual during the course of his/her work (or, if others do assume liability, it is pursuant to an indemnity agreement or other contractual arrangement*).

- The individual does not work at another's facility nor makes substantial use of another's capital; (or, if he/she does, it is pursuant to a limited term, contractual arrangement*)

- The individual's employment requires that he/she own substantial equipment, which is subject to depreciation, and the individual "bargains-for", and receives, compensation which reflects the cost of such depreciation.

- The person or entity files an income tax return attesting that they are self-employed person (e.g. files a Schedule C).

- The person or entity providing compensation to the individual for his/her services does not (and will not) deduct Social Security taxes or federal taxes from the compensation payment.

- Applicable to individuals "selling" services (as opposed to individuals selling goods): The relationship between the "contractor" (the beneficiary) and the contractee is contractual, and changes in the definition or extent of the services provided by the contractor require changes in the contractual agreement. The individual (contractor) exercises a pattern of entering into contractual arrangements* with multiple "contractees" simultaneously, or in succession, and of providing bargained-for, contractually defined services pursuant to an explicit (oral or written) agreement between the individual and the "contractee."

* Contractual arrangement: Provision of goods or services by the individual (a contractor) to another (the "contractee") are contractual if provided pursuant to a "bargained for" agreement in which the individual undertakes to do a specific piece of work, or produce a specified product (as specified in the agreement), for an agreed upon price, within a specific, and limited time period.

It is possible for these indicators to provide conflicting measurements. For example, an individual may not have Social Security or withholding taxes deducted from his compensation and yet the individual is working on another's premises, under another's supervision, subject to another's directions. This scenario may occur where the employment is "under the table." Generally, such an individual would not be considered self-employed.

The county should give consideration to each of the above indicators in conjunction with any other factors that may be pertinent to an individual's job situation. In the case of conflicting measurements, the county must weigh all the indicators and exercise its best judgment. The indicators above are arranged in a hierarchy of perceived importance.

B. DETERMINATIONS OF NET BUSINESS OR SELF-EMPLOYMENT INCOME

1. Medically Needy Program: Determine Net Self-Employ e t Income by subtracting from total business reviews the allowable business deductions per the instructions in Section E below.

2. Section 1931 Program: Instead of determining net business income by subtracting from total business revenue the allowable business deductions per Section B. 1., above, the individual or family may choose that his/her/their net business income be calculated by subtracting from his/her/their total business revenue an amount equal to 40 percent of the total business revenue.

If after being advised by county staff, the individual or family does not indicate his/her/their preferred alternative for computing net business income by the time the county is ready to make a final determination of eligibility, the default method for determining net business income for the Section 1931 program shall be the 40 percent deduction method described in Section B2.

C. COMPUTING NET INCOME FROM SELF-EMPLOYMENT

Section C provides instructions for computing Net Self-Employment Income by subtracting from total business revenue the allowable business deductions.

Section 50505 (Title 22 California Code of Regulations) governs how net income from self-employment is computed. Net self-employment income (business income) is determined by subtracting from the total business revenue those expenses which are "directly related to the production of goods or services, and without which the goods and services could not be produced."

Allowable Expenses: Expenses which are directly related to the production of goods and services, and which are subtracted from business revenue to compute net business income include the following:

1. Material and supply costs;
2. Wages and other benefits paid to employees;
3. Payment for rental of space or equipment;
4. Payment of interest on loans for capital assets or durable goods;
5. Transportation costs to call upon customers or deliver goods;
6. Maintenance and repair costs;
7. Other necessary costs of doing business (e.g. advertising, business dues & publications, and insurance.)
8. Principal and interest payments on capital assets* (equipment, machinery and other durable goods, real estate)*

* Allowable business expenses for Section 1931 program; NOT allowable for MN program.

Expenses Not Allowable: Certain expenses, although connected to business activities, are not considered to be "directly related to the production of goods or services", and cannot be subtracted from business revenue for purposes of determining net business income. These non-allowable expenses include:

1. Entertainment costs;
2. Depreciation;
3. Expenditures to purchase of capital equipment;

4. Payments on the principal of loans used to acquire capital assets or durable goods, **
5. Meals & transportation to and from work.

****Not allowable for MN program, but allowable for Section 1931 program.**

D. VERIFICATION AND RECORDS OF SELF-EMPLOYMENT INCOME

IRS Form Used To Verify Income: This section provides guidelines for the verification and the monthly apportioning of net business income. If the county is using a tax return to verify business income, most of the "business deductions" allowed by the IRS are "allowable" for purposes of determining net business income, except the items list above as non-allowable expenses. Other expenses may not be allowed if they are not related to the business.

If the business was operated throughout the previous year, once the county has determined the net business income for the previous year, apply this previous year's net self-employment income to the current year by apportioning it into the 12 months of the current year by dividing the previous year's yearly net self-employment amount income by 12.

If the county has reason to believe that the business was not operated throughout previous year, the county should determine the number of months in the previous year in which the business was operated and then project the business' yearly revenue and yearly allowable business expenses into the current year by multiplying each by the ratio of 12 (months) divided by the number of months the business was operated in the previous year. After projecting these amounts for the current year, determine net self-employment income for the current year by subtracting from the projected yearly business revenue the projected allowable yearly business expenses. This yearly net self-employment income is then apportioned into the months of the current year by dividing it by 12

Example, the county has a tax return from the previous taxable year from which the county determines there were $12,000 in business revenue and $4000 in allowable business expenses from the previous year. Suppose the county is informed that this business was operational for 8 months of that taxable year. To estimate monthly net business income for the current taxable year (assuming the business will be operational for the entire current taxable year), multiply the $12,000 and $4,000 amounts by the fraction "12/8". The result is a projected $18,000 in yearly business revenue and $6000 in yearly allowable business expenses for the current year. Apportioning these amounts into monthly amounts by dividing them by 12 results in $1500 in monthly total business revenue and $500 in allowable monthly business expenses. Subtracting the $500 in expenses from the $1500 in revenue yields the projected monthly net income from self-employment for the current year of $1000.

County Has Reason To Believe There Should Be An Adjustment: In some situations, last year's tax return may not provide a fair estimate of this year's net business income. If the county has reason to believe that last year's tax return will not provide a reasonably accurate estimate of this year's taxable income, then the county will require the self-employed individual to submit records sufficient to enable the county to estimate net income from self-employment for the current year. See the instructions below for estimating net profit from self-employment when the appropriate IRS tax forms are unavailable or will result in inaccurate estimates of the current year's net self-employment income.

Applicant/Beneficiary Requests Adjustment: An applicant/beneficiary who believes that this year's estimated taxable income based on last year's tax return does not accurately reflect the net income from his business for the current year (due to changes in his/her business' total revenue, or business expenses, or other changes), may request the county to reevaluate his/her net business income based on recent statements of total business revenue and expenses. See the instructions below for estimating net profit from self-employment when the appropriate IRS tax forms are unavailable or will result in inaccurate estimates of the current year's net self-employment income.

Instructions for Estimating Current Year's Income When the Appropriate Last Year's IRS Tax Forms Are Unavailable or Will Result in Inaccurate Estimates of the Current Year's Net Self-Employment Income. In these cases, the county will evaluate the current year's net business income upon receiving from the applicant/beneficiary the required documentation, including an organized, coherent, readable book keeping record or statement of total business revenues and business expenses for at least the last three months (preceding the month in which the request was made), subject to the next paragraph, and subject to the principles discussed in the two examples which follow below. At the county's prerogative, the applicant/beneficiary must submit verification for the business revenue and business expenses shown in the bookkeeping record statement.

It is the applicant/beneficiary's prerogative to submit more than the three statements identified in the paragraph above if he/she feels it would be helpful in estimating his/her income. It is the counties prerogative to request more than the three statements (and corroborating verification), or to request statements for other than the last three months (and corroborating verification), if the county has a reason to believe that it is likely that a substantially inaccurate estimate of net business income would result without the additional information. The county has flexibility to make adjustments in the requirement in this section that the applicant/beneficiary submit a book keeping record or statement for the "last three months."

Example: An applicant has applied for Medi-Cal in June. The applicant is self-employed providing day-care services and her client base is steady throughout the year. She has bookkeeping statements for her business for February, March and April, but has not yet finished preparing statements for May. The county may accept a book keeping record/statements for February through April.

Difficult Situations: Seasonal or Other Fluctuations in Self-Employment: Not infrequently, these kinds of situations require the exercise of considerable judgment; and counties have discretion regarding the methodology to use to estimate net self-employment income. An example is provided below. Although involved, it embodies one of the more difficult self-employment scenarios ever submitted by a county. This example is a sample of one way for a county to approach the problem of estimating the individual's net self-employment income in a difficult situation such as this.

Example: An applicant has applied for Medi-Cal in May. He owns a small crab boat and fishes from September through December last year. He expects to do the same this year. His catch, and income from it, fluctuates substantially from month to month. From January through March of this year he was unemployed. He was unemployed during this period last year. He owns a logging truck, and from April through August of last year he contracted out to several small logging operations to haul felled logs to their mills. His logging contract tends to produce consistent revenue. He has started his trucking operation in May of this year and expects to repeat last year's work pattern. He doesn't have a tax return from last year. He kept poor records.

To repeat: Estimating self-employment income in these situations is difficult, and counties must exercise their judgment and common sense. There are no simple rules that can replace individual judgment for purposes of ensuring a reasonably accurate estimate of the current year's net business income. Credibility of the applicant is a legitimate consideration in determining the extent of verification to require. In this example, assume the applicant appears credible but a little fuzzy on recalling details. Clearly, getting statements and verification for the last 3 months will not suffice to obtain a reasonable estimate of net business income for the year.

In this example, it is reasonable for the county to require verification of business revenue and expenses for the months in which the applicant was self-employed as a fisherman. What constitutes acceptable verification is also subject to judgment. Bank statements for deposited business revenue and receipts for business expenses are obviously acceptable. If the applicant has a credible reason for his inability to provide statements and certain business expense receipts, it may be acceptable, for example, to use estimates of monthly catch and price to estimate business revenue, and trip mileage, fuel utilization, and costs to estimate fuel costs.

Because the applicant has started his trucking operation in the month previous to his application, it is reasonable to expect he should be able to produce statements and verification for his trucking business revenue. These may be complemented by statements and verification of revenue and expenses from last year's trucking operation if the applicant indicates that last year's trucking revenue and expenses to date are not representative.

In short, the county must use its judgment when estimating net business income in these situations.