5 TIPS for

family child care providers

By Tom Copeland, J.D.

1. The area of a provider's basement and garage should be included in the total square footage of the home when calculating the business use of home percentage.
2. A household item purchased for personal use by a provider long before her business began may be depreciated under the normal rules of depreciation once the provider first starts using it in her business. Such items could include furniture, appliances, play equipment, televisions, etc.
3. Lawn care expenses are recognized as a business deduction.
4. The IRS recommended method for handling Food Program reimbursements is to report them as "other income" on Schedule C, rather than netting this income against food expenses.
5. Providers may hire their spouse to do work for their business (without paying a salary), set up a medical reimbursement plan (§105), and deduct uninsured medical expenses as a 100-percent business expense.

These are a few of the many issues clarified by the IRS in its revised edition of the *Child Care Provider Audit Technique Guide* (www.irs.gov/businesses/small/article/0,,id=206004,00.html) published in April 2009. This guide was written to help instruct IRS auditors on how to conduct an audit examination of family child care providers. It also identifies the many unique tax issues and business practices of family child care providers. In 2000 the IRS published the first edition of the *Child Care Provider Audit Technique Guide*. This guide is part of the IRS Market Segment Specialization Program, a series of IRS guides that focus on particular business industries.

The second edition of this guide is a major improvement on the first edition. It offers a greatly expanded explanation of key tax issues and clarifies a number of points in ways that are generally favorable to family child care providers. Read on for more notable issues...

The IRS places a high priority on identifying unreported income. The guide lists 24 questions auditors should ask providers to find out if there is unreported income. Auditors are told to look at a provider's contract for language about payment for illnesses, vacations, late pickup, holding fees, etc. to see if the provider got paid for additional amounts beyond the regular child care rate. The extra attention paid in the guide on this topic implies that auditors may be suspicious about a provider's reported income in an industry where many parents pay in cash and many providers keep inadequate records.

Food program reimbursements should be reported as income. According to the earlier edition of the *Child Care Provider Audit Technique Guide,* as well as IRS Pub. 587, *Business Use of Your Home*, providers were told to net their Food Program income and food expenses on their tax return. This approach is clearly rejected in the new guide, which says that the "recommended method" is for providers to report their Food Program reimbursements as income and food expenses as deductions on Schedule C. This should clear up some confusion about how to handle Food Program reimbursements. The guide also summarizes the 2003 standard meal allowance rule and advises providers to keep daily records of all meals and snacks served, including those not reimbursed by the Food Program.

There are new clarifications on the business-use-of-home calculation. The business-use-of-home calculation is at the heart of any family child care provider's tax return and is always going to be examined in an audit. Because of the thousands of dollars of expenses that will be applied to this formula (property tax, mortgage interest, house insurance, house repairs, utilities, house depreciation, furniture, appliances, play equipment, cleaning supplies, etc.), it's vital for tax professionals to pay particular attention to claiming the maximum percentage that is allowed.

The *Child Care Provider Audit Technique Guide* offers a greatly expanded discussion of how to calculate the business use of the home. It makes it clear that providers must use a regular-use standard rather than an exclusive-use standard that all other home-based businesses must meet. The guide gives an example of a provider who used three bedrooms for naps for the children and notes that auditors should not limit the use of such rooms simply because the provider could put all the children in one room for nap time. Providers may also have an exclusive-use room as well as rooms used regularly for their business (see the Instructions to IRS Form 8829, *Expenses for Business Use of Your Home*).

The guide says that providers who are exempt from state regulations may still deduct expenses on Form 8829. It also states, "An unlicensed provider may still deduct other business expenses such as food, toys, supplies, etc."

The guide references IRS Revenue Ruling 92-3 where a provider was able to count one hour a day spent "cooking, cleaning, and preparing activities" when day care children were not present in the home in calculating the business-use-of-home percentage. The guide notes that this example "is not an absolute rule," meaning that providers are not limited to claiming an hour a day on such activities. I have seen a number of audits where the auditor tried to arbitrarily limit these hours to one hour a day. I have also won a U.S. Tax Court case in which a provider worked an average of 24.8 hours a week on activities when children were not present in the home. This provider had 12 months of carefully prepared records to document these hours.

The garage and basement are part of the home. For the first time, the *Child Care Provider Audit Technique Guide* states that the garage and basement should be included in the total square footage of a provider's home when calculating the business-use-of-home percentage. The inclusion of basements and garages into the Space Percent calculation can have different consequences for providers. For providers who use these areas on a regular basis for their business, and have other rooms that are not regularly used in their business, this is good news because it will increase their Space Percent. For providers who have exclusive use rooms and did not previously count these areas, this is bad news because it will decrease their Space Percent. For providers who use all of their rooms on a regular basis for their business as well as their basement and garage, this inclusion won't make any difference.

In fact, most providers can claim their basement and garage areas as regular use in their business. Most providers have a basement with a laundry room, furnace area, storage area (food, toys, etc.), and tool room area, all of which could be counted as regular use. Most providers have a garage containing a car that is used for business as well as bicycles, household tools, garbage can, storage, etc. The guide cites the *Uphus v. Commissioner*, T.C. Memo 1994-71, for a clear explanation of what constitutes regular use. I was the attorney representing the provider in this case.

Items purchased for personal purposes may later be depreciated as a business expense. Most providers start their business with a house filled with items that will be used in their business. Such items can include washer, dryer, refrigerator, tables, chairs, beds, televisions, lawn mower, play equipment, and so on. The guide clearly states, for the first time in any IRS publication, that such items can be depreciated using the regular rules of depreciation once the items are used in the business. It says, "The fact that the asset was only used for personal purposes prior to being placed in service does not disqualify it from being converted to use in the business." This is a major step forward in clarifying this issue. Tax professionals with clients who have not claimed this depreciation can use IRS Form 3115, *Application for Change in Accounting Method*, to recapture previously unclaimed depreciation on the 2009 tax return.

The IRS is indicating they will apply stricter record keeping rules for listed property. The *Child Care Provider Audit Technique Guide* cites IRC §274, which requires taxpayers to meet a higher record keeping standard (tracking the actual business use) for listed property such as vehicles, computers, cell phones, and property used for entertainment, amusement, or recreation. This could include televisions, DVD players, and stereos. As a practical matter, it is virtually unheard of for a provider to keep a daily log of their business use of such items. I have always recommended that providers use their business-use-of-home percentage to allocate the business portion of these expenses, but the guide may make it harder to argue this position.

Providers can deduct 100 percent of medical benefits paid to a spouse hired to work for their business. The guide discusses the ability of providers to hire employees (including family members) and set up deductible medical and health plans under IRC §105. I won a U.S. Tax Court case in 2006 for a family child care provider who hired her husband to work for her business (without paying him wages) in exchange for a medical reimbursement plan that resulted in a 100-percent-deductible business expense (*Speltz v. Commissioner*, Tax Court Summary Opinion 2006-25).

Providers can deduct the business portion of many household expenses. Family child care providers have always been a unique home-based business in their ability to deduct the business portion of hundreds of household items. The guide acknowledges this by saying "there are many such examples in this industry of expenses incurred for both business and personal purposes." The guide directs the auditor to evaluate "in a fair and objective manner whether the expense is deductible under IRC §162… . It is important to stress the fact that having a personal usage element present does not disqualify the property from being a deductible IRC §162 expense." This clear language should make it a lot easier for providers to properly claim a portion of many household expenses in their business.

The guide gives two examples, one for lawn care and one for laundry facilities, to show providers how they can allocate the business portion by using the business-use-of-home percentage.

Conclusion

The *Child Care Provider Audit Technique Guide* contains many more clarifications on unique issues facing family child care providers. I urge all tax professionals to consult this publication as a helpful guide to what their clients can do to keep adequate records. It can also be used to facilitate communication with an IRS officer during an audit.

Because of my 25 years of experience working in the field of family child care and representing providers at many IRS audits, the IRS asked me for feedback on the guide before it was published (they accepted most of my suggestions). I am very interested in hearing from tax professionals who have audit experiences and ideas for how this guide could be improved. If you share your comments and suggestions with me, I'll pass them on to the IRS. I am also available to offer free advice if your family child care clients are audited. I have written a longer commentary on the guide that you can view at www.nafcc.org, the website for the National Association for Family Child Care. Contact me at tomcopeland@live.com or at 651.280.5991.

Tom Copeland is a licensed attorney and independent consultant who assists family child care providers, trainers, and tax professionals. He has written nine books on the business of family child care, including four on record keeping and taxes. He has spoken at national tax professional conferences and trains thousands of people each year at live workshops and webinars. He has won five U.S. Tax Court cases and regularly answers questions from tax professionals at no fee. From 1981-2009 Tom worked at Resources for Child Caring in St. Paul, Minnesota, where he was the director of Redleaf National Institute for 15 years.