



# Child Care Provider Audit Technique Guide

This document is not an official pronouncement of the law or the position of the Service and cannot be used, cited, or relied upon as such. This guide is current through the revision date. Since changes may have occurred after the revision date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the revision date.

The taxpayer names and addresses shown in this publication are hypothetical.

**Audit Technique Guide Revision Date: 1/11/2022**

# Table of Contents

I. Purpose .....	5
II. Definitions: Types of Child Care Providers.....	5
A. “Kith and Kin” (Care Provided by Relatives, Friends and Neighbors):.....	5
B. Family Day Care .....	5
C. In-Home Care.....	6
D. Babysitters .....	6
E. Others .....	6
III. Status.....	6
IV. Income Issues.....	7
A. Introduction .....	7
V. Income Audit Techniques.....	7
A. Interview .....	7
B. Income from Records .....	9
C. Reconstruction Methods to Verify Income or Reconstruct Income .....	9
C.1. Examples of Using This Information .....	10
VI. Food Program Reimbursements (CACFP) .....	13
A. How to Report Food Reimbursement Payments.....	13
VII. OTHER INCOME.....	13
VIII. Expense Issues .....	14
A. Introduction to Expenses – Determining the deductible amount under IRC Section 162 and the business usage percentage in child care provider businesses .....	14

<b>IX. Substantiation Requirements of IRC Section 274(d) and IRC Regulation 1.274-5T.....</b>	<b>15</b>
<b>A. DEPRECIATION.....</b>	<b>16</b>
<b>A.1. Elements Required to Be Substantiated under IRC Section 274(d) for Listed Property:.....</b>	<b>17</b>
<b>X. Vehicle (Car and Truck) Expense.....</b>	<b>18</b>
<b>XI. Travel, Meals, Entertainment.....</b>	<b>19</b>
<b>A. Food Expense .....</b>	<b>20</b>
<b>XII. BUSINESS USE OF THE HOME.....</b>	<b>21</b>
<b>A. Introduction .....</b>	<b>21</b>
<b>B. Requirements to Qualify for Business Use of Home Deduction for Day Care Facilities (Regulatory) .....</b>	<b>21</b>
<b>C. Limitation on Deduction (Regulatory).....</b>	<b>22</b>
<b>D. Regular Use Versus Exclusive Use.....</b>	<b>22</b>
<b>E. Determining Business Percentage.....</b>	<b>23</b>
<b>F. Figuring the Allowable Deduction .....</b>	<b>24</b>
<b>G. Tax Exempt Income Used for Payment of Housing Used in Day Care .....</b>	<b>25</b>
<b>G.1. Depreciation of the Home.....</b>	<b>26</b>
<b>G.2. Modifications to the Home .....</b>	<b>27</b>
<b>G.3. Sale of Home.....</b>	<b>27</b>
<b>XIII. Toys.....</b>	<b>28</b>
<b>XIV. Advertising .....</b>	<b>28</b>
<b>XV. Bad Debts .....</b>	<b>28</b>
<b>XVI. Commissions and Fees.....</b>	<b>28</b>

<b>XVII.</b>	<b>Employee Benefit Program/Pension and Profit Sharing .....</b>	<b>29</b>
<b>A.</b>	<b>Insurance .....</b>	<b>29</b>
<b>B.</b>	<b>Office Expenses and Supplies.....</b>	<b>29</b>
<b>C.</b>	<b>Rent .....</b>	<b>30</b>
<b>D.</b>	<b>Start-Up Costs (paid or incurred after October 22, 2004).....</b>	<b>30</b>
<b>E.</b>	<b>Organizational Costs of Corporations or Partnerships (paid or     incurred after October 22, 2004).....</b>	<b>30</b>
<b>F.</b>	<b>Telephone Expense .....</b>	<b>31</b>
<b>G.</b>	<b>Utilities .....</b>	<b>31</b>
<b>H.</b>	<b>Bank Charges.....</b>	<b>31</b>
<b>I.</b>	<b>Gifts .....</b>	<b>31</b>
<b>J.</b>	<b>Other Expenses.....</b>	<b>31</b>
<b>K.</b>	<b>Wages/Compensation .....</b>	<b>31</b>
<b>XVIII.</b>	<b>Employee Versus Independent Contractor .....</b>	<b>32</b>
<b>XIX.</b>	<b>Exhibit A Sample IDR .....</b>	<b>34</b>
<b>XX.</b>	<b>Exhibit B Internal Revenue Regulation 1.280A-2(i).....</b>	<b>36</b>

## **I. Purpose**

- (1) This Audit Techniques Guide (ATG) will provide information to enable examiners to effectively audit issues pertaining to child care providers. The ATG will:
  - Provide background information
  - Identify frequent and/or unique issues
  - Provide examination techniques
  - Supply applicable law

## **II. Definitions: Types of Child Care Providers**

### **A. “Kith and Kin” (Care Provided by Relatives, Friends and Neighbors):**

- (1) These caregivers are generally the most informal type of child care providers. It is often called "Kith and Kin" care and can take place in the caregiver's home or in the child's home. In some instances, the provider will be a spouse caring for his/her own children and also taking care of one or two additional children for the extra income. Others can be grandparents or other relatives, friends, or neighbors who welcome the extra money or are not paid, but are willing to look after the children. This type of care is generally not under much regulatory control and in some states may be exempt from licensing requirements. These providers often believe that this income is not taxable and, therefore, need not be reported. However, this could result in both taxable income and self-employment tax. Child care provided in the child's home by a household employee, which is discussed under In-Home Care, is also a concern.

### **B. Family Day Care**

- (1) This type of child care is usually provided in separate facilities apart from the owner's residence. Many child care centers are organized as corporations (Form 1120), S corporations (Form 1120S) or partnerships (Form 1065). There may be more than one facility operated by a corporation or partnership. There may be one or more shareholders or partners involved in several facilities, each of which may be organized as a separate corporation or partnership. All states require child care centers to be licensed, although the specifics of each will differ. Contact the applicable state or local agency for their regulations using the link below. These centers may be required to report attendance records or other similar information. They may have large commercial kitchens, playground equipment, swimming pools, and large quantities of toys.

## C. In-Home Care

- (1) Some children are cared for in their own homes by a paid housekeeper, maid, governess, au pair or nanny. The home caregiver is generally paid as a household employee. The parents show the wages on Schedule H attached to their Form 1040. This situation is not a child care provider business. The nanny, housekeeper, etc. receives wages but does not incur expenses as a child care provider. For more information see Topic 756 - Employment Taxes for Household Employees. Most states do not regulate in-home caregivers, but some states regulate nanny-placement agencies.

## D. Babysitters

- (1) Lastly, babysitters provide child care in the child's home on an irregular basis, such as when the parents go out to an event leaving the children under the care of a college student. The income of a babysitter is taxable income.

## E. Others

- (1) There may be other types of child care providers, such as after-school programs, church programs, or other tax-exempt entities. These are not specifically addressed in this document. The National Resource Center for Health and Safety in Child Care and Early Education provides links to individual state's child care regulations, as well as licensing and child care-related contacts.

## III. Status

- (1) This guide will focus on the income and expenses of a child care provider. Examination of these returns may result in the following determinations:
  - Income is frequently understated and may be paid in cash.
  - Expenses are often overstated and may be paid in cash
  - Record keeping is often inadequate.
  - Issues most often adjusted include:
    - Gross receipts
    - Food reimbursement
    - Food expense (may include personal expenses)
    - Business use of home
    - Unusually large expenses
    - Supplies and miscellaneous expenses (may include personal expenses).

## IV. Income Issues

### A. Introduction

- (1) Whether the child care provider is a babysitter, “Kith & Kin” type provider, a family day care operator or a child care center, the income from the activity is taxable income. The net income is subject to self-employment tax, if applicable, with the exception of a provider who is organized as a separate entity, such as a corporation. The income and expenses of sole proprietors should be reported on Form 1040, Schedule C (or C-EZ), with the net income reported on Schedule SE to compute self-employment tax, if applicable. Partnerships report their income and expenses on Forms 1065 with the net income passing to the partners on Forms K-1 and reported on their Forms 1040, Schedule E, and Form SE, if applicable. Similarly, S corporations report their income and expenses on Forms 1120S and pass through the net income to their shareholders to be reported on their Forms 1040. C corporations report their income and expenses on Forms 1120. [Note: Some providers may be doing business as limited liability companies (LLCs). LLCs may be taxed as Schedule C businesses, as partnerships, or as corporations, depending on the circumstances. [See IRC Regulations 301.7701-1, 301.7701-2, and 301.7701-3]
- (2) The records available will range from nonexistent to a very sophisticated electronic set of books and records depending on the size of the provider and the bookkeeping and tax knowledge of the provider. Income may be received from the parents, business entities, government subsidies, food program reimbursements including the Child & Adult Care Food Program (“CACFP”) discussed below, and nonprofit organizations. The audit techniques used will be based on the facts and circumstances of each case.

## V. Income Audit Techniques

- (1) Audit techniques required are in IRM 4.10.4 and summarized on the Examiner’s Mandatory Lead Sheet Work Paper #400 “Minimum Income Probe Lead Sheet”. The following provides information specific to this industry to assist in performing the various income analyses.

### A. Interview

- (1) The answers to the questions below will provide you with the information that is available to verify that income is correctly reported and what sources are available to do an indirect method if necessary:
  - Ask how the provider determined the income for the business.
  - Does the provider maintain any records of the income received? What kind of records?
  - Does the provider have a contract with the children’s parents? If yes, ask for the contract.

- Does the provider have a rate schedule? Is the same schedule used for all children or do some have a special rate? Determine which children have a different rate and the amount. If the provider does not have the rate schedule for the year in question, ask for the current rate schedule and then ask how it differed in the tax year under exam.
- What is the policy for payment when the child is absent due to illness, vacation, etc.?
- Does the provider get paid vacation? (Are the fees due for the period the provider takes agreed upon vacation?)
- Does the provider have a fee policy for when the parents drop their children off early or are late picking up the children?
- Does the provider have a special charge when the child is left beyond the normal business hours on certain days or occasions in which the provider agrees to keep them longer?
- Does the provider ever keep children overnight?
- Does the provider furnish transportation to and from school, field trips, etc.? Is it part of the contract price or is there extra charge for either service?
- For infants and toddlers who wear diapers, does the provider furnish diapers? Is there an extra charge? If the parents provide diapers, does the provider charge for diapers used above what was provided, if needed? How does the provider keep track of extra charges for diapers?
- Does the provider charge holding fees? (fees to hold a position for a child prior to the child coming to the facility)
- Does the provider charge a registration fee? A fee to cover the cost of the provider's time to interview the parents, prepare contracts, collecting enrollment information, etc.? If yes, ask if the state ever paid the registration fee, which is done in some states.
- Does the provider have a sign-in, sign-out sheet for the parents?
- Does the provider have attendance sheets?
- Does the provider have emergency contact information?
- Does the provider have permission for medical treatment forms for the children in the program?
- Does the provider have parent permission slips for field trips?
- Does the provider receive payments from sources other than the parents, such as food program reimbursements (CACFP), payments from the parent's employer, grant payments from a nonprofit organization, etc.? If yes, then inquire how the provider records the payments or keep track of



what was received and if the provider needs to submit any records to get the payments, such as reports to get the CACFP payments. Do the payments include any amounts for the provider's own children?

- If there is a bad weather day and the child does not come, does the parent still have to pay?
- Does the provider furnish year-end statements to the parents as to how much they paid in the tax year?
- Does the provider furnish meals and snacks or do parents send food with the children? If meals and snacks are provided, ask for details of what kind of meals (breakfast, lunch, dinner) and how many snacks.
- For providers who have facilities not in their home, ask if they rent out the facilities during nonbusiness hours. Some providers do this especially on weekends.
- Ask if the provider was granted a loan to purchase business equipment whose principal was forgiven. If yes, then ask what the terms of the forgiveness were and if the loan was forgiven during the year under examination, then the amount forgiven is taxable income.

(2) **Note:** For all yes answers, use follow-up questions to get details.

## **B. Income from Records**

- (1) If the provider maintains records, tie the records to the return. Test the completeness of the records against other sources you discover in the interview, such as sign-in and sign-out sheets, contracts, attendance records, year-end receipts, emergency contact information, etc. Verify that all the children that are cared for are accounted for in the records. Check for the reporting of extra charges, such as late fees, trip fees, etc. Question any significant fluctuations in the weekly/monthly income.

## **C. Reconstruction Methods to Verify Income or Reconstruct Income**

- (1) The method to be used will be determined on a case-by-case basis depending on the amount of records and source documents available. Some small providers, such as the "Kith and Kin" types, might have minimal records or documents. The bank deposit method is a good method since many parents pay by check to have proof of payment for the child care credit. However, for "Kith and Kin" type, it may not be the best method to test or reconstruct income since there might be a lot of cash transactions in this business. The Cash-T might not be helpful since the income from the provider business may not be the main source of support. Bank account deposit details can provide information, such as the parent's name and payments amounts, and provide a

source for making third- party contacts. Third-party contacts may or may not be effective in “Kith and Kin” type businesses because there might be a close personal relationship with the provider. Be sure to follow third-party contact procedures (IRM 4.10.1.6.12).

- (2) Various methods to reconstruct income can be created using the information from the rate schedules, contracts, attendance records, sign-in and sign-out sheets, year-end statements, food program statements, etc. (Note: Under IRC Section 7602(e), the Service may not use indirect methods to reconstruct income unless it “has a reasonable indication that there is a likelihood of...unreported income.” See IRM 4.10.4 for the techniques that should be employed to determine whether there is a likelihood of unreported income.)

### **C.1. Examples of Using This Information**

- (1) **"Kith and Kin" type where no records exist**
- (2) In the interview, the provider responded that she/he took care of two children from the same family and was paid \$200 per week. The children were in the home 50 weeks of the year. No payment was received when the taxpayer took off two weeks for vacation and no extra fees were charged for any other services, such as diapers, field trips, etc. A review of several of the bank deposits showed recurring \$200.00 deposits most weeks. Other deposits, except for immaterial ones, could be traced to other sources of income.
- (3) Income can be computed by multiplying \$200.00 times 50 weeks, which equals \$10,000.00 gross receipts. Compare the result to the tax return, and if it is significantly different than the amount reported, follow up with additional questions. Absent any reasonable justification, you may base the adjustment on the indirect method.
- (4) **Using sign-in/out sheets, rate schedules, etc. to verify income sample**
- (5) Facts: A family day care provider reported income using the bank deposit information from the account maintained for the business. The sign-in/out sheets were used to create a client list with the appropriate period of time the child was a client. Emergency contact information sheets were used to verify that all children being cared for had been accounted for. The provider stated in the interview that all children were charged the same rate of \$250.00 per week. The business was open 50 weeks during the tax year, and the provider did not charge for their two-week vacation. The sign-in/out sheets showed there were a few changes in the children cared for during the tax year. The policy of the business was that parents had to pay the provider for absences and vacations of the children. No extra fees were charged except for early drop-off and/or late pick-up. The sign-in/out sheets showed this was not a meaningful occurrence, hence it should be disregarded in the computation based on materiality.
- (6) Computation and Adjustment - Income was reconstructed using the records as follows:

- Child 1 50 weeks times 250.00 equal \$12,500
  - Child 2 30 weeks times 250.00 equal \$ 7,500
  - Child 3 50 weeks times 250.00 equal \$12,500
  - Child 4 50 weeks times 250.00 equal \$12,500
  - Child 5 20 weeks times 250.00 equal \$ 5,000
  - Child 6 45 weeks times 250.00 equal \$11,250
- (7) The total reconstructed income came to a grand total of \$61,250. The reported income was \$38,400 based on the bank deposit records. Hence it appears income was understated by \$22,850. Remember to discuss the methodology and results with the provider to determine if there were other factors you did not consider. Adjust your computation as needed and make the appropriate income adjustment.
- (8) **Reconstruction of gross receipts using a food reimbursement formula**
- (9) Facts: The taxpayer received food reimbursement from a local government agency of \$6,501 for the year under Tier 1. (The difference between a Tier 1 & 2 rates is explained in the following section.) The taxpayer provided lunch and two snacks per day, per child.
- (10)**Note:** Be sure to ask the taxpayer how many meals and snacks are provided per child and, of these, how many are subject to a reimbursement program as well as if they are reimbursed under Tier I or II and if any of the taxpayer's children are covered by the program. Also, request a copy of the reimbursement application (or other submissions), which should show the number of child days that were used to determine the amount of the subsidy.
- (11)The reimbursement meal rates are \$1.97 for lunch and \$ .58 per snack, totaling \$3.13 per day for Tier I (see sample rates below).
- (12)**Note:** because the reimbursement rate changes mid-year for any exam year use the 2nd half of the year's rate which is usually higher. The difference is not material and is in the advantage of the taxpayer hence more conservative for a reconstruction method. (i.e., for the exam year 2007 use the 2007/2008 rate. The average fee per child per five day week is \$200.
- (13)The computation, using the facts above is as follows:
- Step 1: Divide the annual reimbursement amount (\$6,501) by the daily reimbursement rate (\$3.13) to arrive at the number of "child days" (2,077).
  - Step 2: Divide the number of "child days" (2,077) by the days of the operating week (5) to arrive at "child weeks" (415).
  - Step 3: Multiply the "child weeks" (415) by the weekly fee (\$200) to arrive at the tentative gross receipts (\$83,000).

- (14) Use this formula as a guide to determine if gross receipts appear reasonable. You should modify the computation methodology if the weekly fee changes during the year or if the fee charged is not uniformed for each child under the care of the provider to get a more realistic average weekly fee rate to use. Discuss with the taxpayer other factors that may make this method result in any significant discrepancy and modify the methodology base on those factors. If the taxpayer's own children are enrolled in the food program, reduce the gross receipts by the appropriate amount. This formula may be used for any number of children. If some of the children do not qualify for a reimbursement program, add the annualized fee for these children to the reconstructed gross receipts.
- (15) **Note:** The reimbursements from the food program are usually received in the month following the expenditure.

<b>Tier I</b>			
<b>Meal Type</b>	<b>2005/2006</b>	<b>2006/2007</b>	<b>2007/2008</b>
Breakfast (meal)	\$1.06	\$1.06	\$1.11
Lunch (meal)	\$1.96	\$1.97	\$2.06
Dinner (meal)	\$1.96	\$1.97	\$2.06
<b>Tier I</b>			
<b>Meal Type</b>	<b>2005/2006</b>	<b>2006/2007</b>	<b>2007/2008</b>
Supplement (snack)	\$0.58	\$0.58	\$0.61
<b>Tier II</b>			
<b>Meal Type</b>	<b>2005/2006</b>	<b>2006/2007</b>	<b>2007/2008</b>
Breakfast (meal)	\$0.39	\$0.39	\$0.41
Lunch (meal)	\$1.18	\$1.19	\$1.24
Dinner (meal)	\$1.18	\$1.19	\$1.24
Supplement (snack)	\$0.16	\$0.16	\$0.17

- (16) Reimbursement rates are for July through June from the U.S. Department of Agriculture, Child and Adult Care Food Program (CACFP), for Tier 1 and Tier 2. Reimbursement rates should be obtained from the applicable state agency, which will also provide the guidelines for making a Tier I or Tier II reimbursement determination. You can get the rates at the United States Department of Agriculture Web site.

## **VI. Food Program Reimbursements (CACFP)**

- (1) The United State Department of Agriculture provides reimbursement to day care providers through the CACFP. The CACFP is authorized by Section 17 of the National School Lunch Act (42 U.S.C. 1766). The USDA administers the CACFP through grants to the states. The actual agency involved can vary by state. Independent centers and sponsoring organizations can enter into agreements with the individual states to administer the program.
- (2) The day care provider must sign an agreement with the state or sponsoring organization to participate in the CACFP. The provider must be licensed or approved to provide day care services in order to participate. Reimbursement for meals served in day care homes is based upon eligibility for Tier I rates (which targets higher levels of reimbursement to low-income areas, providers, or children) or the lower Tier II rates. Tier I day care homes are those that are located in low-income areas, or those in which the provider's household income is at or below 185 percent of the federal income poverty guidelines.
- (3) Sponsoring organizations may use elementary school free and reduced price enrollment data or census block group data to determine which areas are low-income. Tier II homes are those family day care homes which do not meet the location, parent income, or provider income criteria for a Tier I home.
- (4) Program payments for day care homes are based on the number of meals served to enrolled children, multiplied by the appropriate reimbursement rate for each breakfast, lunch, supper, or snack they are approved to serve. Reports showing the meals provided to the children are submitted to the administering agency and can be useful in verifying income, discussed in detail under techniques.

### **A. How to Report Food Reimbursement Payments**

- (1) Food reimbursement payments are sometimes reported on a Form 1099. If a provider received a Form 1099, the best way for the provider to report those payments is under the "Other Income" section of the Schedule C and writing in "CACFP Income." The provider should not include the amount of the payments for his/her own children because it is not taxable. Clearly reporting the CACFP payments in this manner will assist the IRS in the selection of returns for examination. If no 1099 is received, the provider can report it under other income or as an alternative method net the payments against the food expense.

## **VII. OTHER INCOME**

- (1) Other income may come from interest bearing accounts, dividends from investments, rental fees, or from the sale of assets.
- (2) Child care centers which have facilities separate from the home may rent out the facilities during nonbusiness hours to others for a fee. Some examples are

weekly meetings of religious organizations, social clubs, investment clubs, kids clubs, etc., as well as one time events, such as fundraising activities of charitable or social club organizations or for family events (weddings).

- (3) Some child care providers might be granted a loan to purchase business equipment whose principal is forgiven after the passage of a certain amount of time. If this situation exists, then the loan forgiveness is taxable income reportable on Schedule C.

## **VIII. Expense Issues**

### **A. Introduction to Expenses – Determining the deductible amount under IRC Section 162 and the business usage percentage in child care provider businesses**

- (1) The examination of expenses of the child care provider can be a challenge to the examiner because many of the items being expensed are used for both business and personal purposes. Because of this unique feature of the provider, Congress passed a special provision of the IRC to provide the method to compute the business use of the home deduction, which is discussed below.
- (2) Other deductions, such as depreciation of fixed assets, amounts spent for toys, supplies, appliances, vehicle expenses, etc. may pose the same problem to the examiner. The provider is entitled to a deduction of the business use portion, subject to the limitation of the law for some deductions, such as vehicle depreciation (IRC Section 280F). In some cases, the property might be substantially used in the business, while in other cases it might be minimally used.
- (3) The examiner needs to evaluate in a fair and objective manner whether the expense is deductible under IRC Section 162 as an ordinary and necessary expense and then determine what percentage constitutes business usage based on the facts and circumstances of each case. It is important to stress the fact that having a personal usage element present does not disqualify the property from being a deductible IRC Section 162 expense. A few examples of this are:
  - Lawn expenses: If the children play outside in the yard on a regular and ongoing basis, then the expense of maintaining the yard, such as the amount charged by a lawn mowing service, has a business usage element and should be partially allowed. An appropriate business usage percentage could be the business use of the home percentage.
  - Laundry facilities and soap to wash towels, blankets, etc. used by the children: This is a necessary business expense for which the business usage of the home percentage would be appropriate based on materiality.
- (4) There are many such examples in this industry of expenses incurred for both business and personal purposes, and the examiner must be careful to first

apply the IRC Section 162 criteria and then the facts and circumstances of the case to determine the deductible business portion of the expense.

- (5) Another area that must be kept in mind is the substantiation rules of IRC Section 274(d), discussed below, which requires specific information to be maintained in the provider's records for certain types of expenses to be allowed.

## **IX. Substantiation Requirements of IRC Section 274(d) and IRC Regulation 1.274-5T**

- (1) IRC section 274(d) provides that no deduction shall be allowed under IRC sections 162 or 212 for any expenditure away from home unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his or her own statement the amount, time, place and business purpose of the expenditure for travel.
- (2) IRC Regulation 1.274-5(c)(2)(iii) requires the taxpayer to have documentary evidence such as receipts or paid bills to support an expenditure for all lodging while away from home and all other expenses over \$75 (except for transportation charges).
- (3) IRC Regulation 1.274-5T(b) provides a list of the elements required to substantiate expenditures for travel, gifts and listed property.
- (4) **Note:** IRC Regulations 1.274-5(c) and 1.275-5T have not been updated for The Tax Cuts and Jobs Act (TCJA) of 2017, P.L. 115-97, section 13304 which significantly amended IRC Section 274. Under the TCJA, the entertainment expense category was removed from the substantiation requirements under this regulation. This is because under TCJA, IRC Section 274(a)(1) now disallows a deduction for any activity that is generally considered to be entertainment, recreation, amusement or qualified transportation fringes paid or incurred after December 31, 2017, even if related to the taxpayer's business, unless it meets one of the exceptions described in IRC Section 274(e).
- (5) Publication 463 (Travel, Entertainment, Gifts and Car Expenses) and Publication 946 (Depreciation (section on Listed Property)) summarize the key elements of the law in plain English.
- (6) Listed Property is defined in IRC Section 280F and IRC Regulation 1.280F-6(b) to include vehicles, and property used for entertainment, such as photographic (cameras), phonographic, communications and video recording equipment (camcorders). (Note: Property used for entertainment are not Listed Property if they are used exclusively at the taxpayer's business establishment or exclusively in connection with his principal trade or business.) There are additional requirements for depreciated Listed Property, which is discussed in the next section.

## A. DEPRECIATION

- (1) Depreciation (IRC Sections 167, 168 and 179) may be available for computers, vehicles, office equipment, kitchen equipment, playground equipment, furniture, appliances, etc., and any fixed asset that has a useful life over one year.
- (2) Challenges: An Examiner is faced with two main concerns in addition to whether the expense is ordinary and necessary under IRC Section 162:
  - The Business Use Percentage: The facts and circumstances of each case should be used to determine the business use percentage. For Listed Property, discussed below, the provider is required to keep records as to usage. It is recommended that some records of business usage and total usage be kept for other items also. For furniture and furnishing, the business use of the home percentage may be appropriate.
  - The basis to be depreciated: If the provider purchased the item in the year it was placed in service in the business, the basis is the cost. For many providers, when they start their business many items which were personal use only are used in the business. They are entitled to depreciate the business use portion of those assets. For assets purchased prior to being placed into service, the basis for depreciation is the lower of the cost or the fair market value at the time the asset is placed in service. Determining fair market value has been an area of controversy and must be resolved on a case-by-case basis. A good starting point for determining the fair market value is to go to some of the sites which provide valuations of those items for charitable donations purposes, such as: Salvation Army donation valuation site: The Salvation Army: Donation Receipts - Valuation Guide
- (3) 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. You would still need to value it as described above and apply the appropriate business use percentage, which does not need to be 100% business use and usually is not.
- (4) IRC Section 179 allows some qualifying assets to be expensed in the year they are purchased and put into service up to the limit set by the law, which can change from year- to-year.
- (5) Special depreciation allowances in addition to the normal depreciation deduction can be granted by Congress for periods of time or for special locations, such as federally declared disaster areas.
- (6) Check the law or Publication 946 for the year the asset is purchased and placed in service to determine the amount of the depreciation deduction allowed and the criteria to take the additional deduction as well as the Section 179 amount and limits.



- (7) Listed Property, which includes vehicles, have special substantiation rules found in Section 274(d) as well as limitations on usage and the amount of the deduction (discussed below).
- (8) Less than 50% Business Usage of Listed Property (IRC Section 280F): If the business usage of listed property is less than 50%, the asset does not qualify for an IRC Section 179 deduction, and the taxpayer must use the Alternative Depreciation System under IRC Section 168(g) since the asset cannot be depreciated using MACRS. If the business usage falls to under 50% in a subsequent year, then the provider is required to “recapture” the amount of depreciation previously claimed that exceeds the amount that would have been allowed had the business usage been less than 50% the whole time.
- (9) Passenger Automobiles (limitation of IRC Section 280F): For passenger automobiles, there is an additional limitation for the total amount of depreciation allowable for each year, which is adjusted each year for inflation. Refer to Publication 463 for details on the limits and other related sections on car expenses.

#### **A.1. Elements Required to Be Substantiated under IRC Section 274(d) for Listed Property:**

- (1) IRC Section 274(d), discussed above, requires the taxpayer (provider) to “substantiate by adequate records or by sufficient evidence corroborating the taxpayer’s own statement” the expenses listed in that section.
- (2) Under IRC Regulation 1.274-5T(b)(6), the taxpayer must substantiate the following items to be allowed a deduction for Listed Property:
  - The amount of each separate expenditure, such as the cost of acquiring the item, maintenance and repair costs, capital improvement costs, lease payments, and any other expenses;
  - The amount of each business use (based on an appropriate measure, such as mileage for vehicles and time for other Listed Property), and the total use of the property for the tax year;
  - The date of the expenditure or use; and
  - The business purpose for the expenditure or use.
- (3) The records should be made at or near the time of the expenditure or use.
- (4) For more details and information on Listed Property and what records must be kept, refer to Publication 946 and IRC Regulations 1.280F-6, 1.274-5T, and 1.274-6T.
- (5) **Note to Examiner:** Use RGS Lead Sheets for audit steps.

## X. Vehicle (Car and Truck) Expense

- (1) Child care providers generally will incur expenses related to a vehicle, which is Listed Property as defined in IRC Section 280F. The extent of the vehicle usage for business will depend on the type of provider, the age of the children, and the type of activities they offer in the regular course of their business. Some typical expenses relate to taking children to and from school, field trips, medical facilities, and trips to buy business- related supplies, etc.
- (2) The provider is allowed to deduct either the business use percentage of actual vehicle expenses incurred primarily for business or the standard mileage rate for the business miles, depending on the facts and circumstances. However, since vehicles are Listed Property, the provider is subject to the substantiation rules under IRC Section 274(d) and the related regulations, especially IRC Regulations 1.274-5T and 1.274-6T, for Listed Property or no deduction will be allowed. Section 274 substantiation is discussed above and the elements are listed in the Depreciation section above. Examiners need to review the documentation to verify that it conforms to the legal requirements. In child care centers, it is not uncommon to maintain vans for transporting children, which are substantially used for business, hence the substantiation requirements would be different.
- (3) Primarily for Business: Some trips are obviously primarily for business, while others might be personal or a combination of both. If a taxpayer travels to a single destination and engages in both personal and business activities, the expense is deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the expense is not deductible even though the taxpayer engages in business while at such destination. Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip spent on personal activities compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. If a trip involves multiple locations, then the examiner needs to determine for each location whether it was primarily for business and allow as deductible only the mileage to/from the business purpose location. For example: A provider went 6 miles to destination A (primarily business purpose), then 5 miles to destination B (primarily personal purpose) and then 9 miles home, the provider could deduct 12 miles as a business expense (roundtrip home to destination A).
- (4) For an activity to be classified as a "trade or business," there must be a profit motive present, and the expense must be ordinary and necessary. If the examiner finds that expenses or trips being claimed seem unreasonable for any trade or business expecting to make a profit, a probe of additional factors should be made. Are there additional fees being collected for the field trips or other trips that were not reported as income? Was the trip during the normal

time for the operation of the business? Who participated in the trip? Did most of the children participate? Is there a family or other special relationship with the children which might move the expense from being an ordinary or necessary expense of a trade or business to a personal one? This issue may more commonly be found in the “Kith and Kin” type businesses. Use the facts and circumstances of each case to determine the issues that may exist.

- (5) References: See IRC Section 274 and related regulations, Publication 463, Travel Entertainment, Gift and Car Expenses, for more details on the standard mileage rate versus the deduction of actual expenses, the recordkeeping requirements, and other valuable information.
- (6) Note to Examiner: Use the RGS lead sheet for the audit steps. Be careful to verify the substantiation in accordance with IRC Section 274.

## **XI. Travel, Meals, Entertainment**

- (1) Most providers are licensed and are required to take courses to maintain their license. In addition, there are numerous child care organizations that sponsor conventions and seminars which providers attend. There might be local classes being offered or gatherings of child care providers in an area that will help the provider in providing a better product to the children. The provider may also meet with clients or employees. Some activities require travel away from home and others might be local but include meal expenses.
- (2) Travel, meals and entertainment are covered under IRC Section 274 and the related regulations including IRC Regulation 1.274-5T, which deals specifically with the substantiation requirements. See the section above entitled “Substantiation Requirements of IRC Section 274(d) and IRC Regulation 1.274-5T” and IRC Regulations 1.274-5A and 1.274-5T. Under Section 274(n), meal expense is subject to a 50% limitation, except meals (food) and entertainment expense provided to the children under the provider’s paid care is fully deductible. See the “Food Expense” section below.
- (3) In addition to the IRC Section 274 requirements, for the provider to be able to deduct the expense, the provider must be a “trade or business” and the expense must be an ordinary and necessary expense. To be a trade or business, there must be a profit motive present. While following the normal audit steps, for each expense the examiner should review the business purpose, the business relationship for meals and entertainment, and the actual expenses to determine if the expense is an ordinary and necessary expense. He/she might find that some persons who the provider has a business relationship with also have a close personal or family relationship with the provider. This should not be the sole reason to disqualify the expense. The examiner needs to look at all the facts and circumstances together before deciding whether it is an ordinary and necessary expense.
- (4) **Note to Examiner:** Use the RGS lead sheet for the audit steps

## A. Food Expense

- (1) Providers deduct the cost of food in several different places on their returns including, but not limited to, the "Cost of Goods Sold" line, the "Supplies" line, or the "Other Expenses" line.
- (2) IRC Section 162 allows a deduction for food provided to the day care recipients. This amount is not limited by the 50% reduction imposed under IRC Section 274(n). See IRC Regulation 1.274-12(c)(2)(iv)(B)(3).
- (3) Under IRC Section 262, no portion of the cost of food provided to the provider's family, including food consumed by the provider or the provider's own children, is allowed as a deduction.
- (4) If the provider receives reimbursement for food costs through the CACFP (discussed above) or any other program, the provider can report all the reimbursements under the income section of Part I of the Schedule C and then deduct the food expenses in full, which is the recommended method especially when the provider receives a Form 1099 from the program, or the provider can net the amount reimbursed against the food expense. If the provider uses the netting method and the food expense is greater than the reimbursement, then the provider may deduct the excess as a food expense. If the reimbursements exceed the total food expenses, then the provider should report the excess income in Part I on the Schedule C. The netting method is not a preferred method since an Examiner will always be looking for the food reimbursement amounts. When you report the amount separately, the Examiner will more easily be able to account for the payments.
- (5) **Note to Examiner:** Food reimbursement payments from the sponsors are received approximately one month after the expense is incurred.
- (6) For food provided to employees, generally only 50% of the cost of food consumed is deductible. For expenses incurred after 12/31/2017 this includes the cost of food consumed by their employees if its value can be excluded from their wages as a de minimis fringe benefit. For more information on meals that meet these requirements, see Meals in chapter 2 of Publication 15-B, Employer's Tax Guide to Fringe Benefits.
- (7) Food may be bought in large quantities in larger child care operations. Freight charges may be included in the food account. Some centers might have special occasion activities for the children in which the parents are invited, such as Christmas, where meals are provided. Such special occasion costs are deductible as a special activity cost.
- (8) **Substantiation Requirement:** IRC Section 6001 and IRC Regulation 1.6001-1(a) provide that every person must keep records to substantiate the amount of any deduction. If the provider deducts the actual food expense incurred, they must maintain receipts which clearly identify the cost of the food allowed as an

IRC Section 162 trade of business expense from those costs that are nondeductible personal expenses under IRC Section 262.

- (9) Revenue Procedure 2003-22 was issued 2-24-2003 to simplify recordkeeping requirements by providing an optional standard meal and snack rates that “family day care providers” may use in computing the deductible cost of food provided to eligible children in the day care in lieu of actual costs. The rate is based on the Tier I rate under the CACFP. The provider may use the standard meal and snack rate for a maximum of one breakfast, one lunch, one dinner, and three snacks per eligible child per day. There is still a recordkeeping requirement, which includes the name of each eligible child, dates and hours of attendance in the family day care, and the type and quantity of meals and snacks served. More information on this method, including which providers qualify and who is an eligible child, can be found in Publication 587 under the chapter Daycare Facilities specifically the section entitled “Standard Meal and Snack Rates.” A sample log can be found in Exhibit A, which is at the end of the Publication.
- (10) If the provider chooses to use the standard meal and snack rates, he/she must do so for the complete tax year. The provider cannot use the actual method during that tax year but can switch methods in a subsequent tax year if he/she wishes.
- (11) **Caution to Examiners:** The standard meal and snack rate method in Revenue Procedure 2003-22 is available to a trade or business which provides child care to eligible children in the home of the provider that is (1) nonmedical, (2) does not involve a transfer of legal custody, and (3) generally lasts for less than 24 hours each day. The revenue procedure applies to any “family day care provider” whether or not the provider received reimbursements under the CACFP or is registered, licensed, or regulated by the state in which it operates.

## **XII. BUSINESS USE OF THE HOME**

### **A. Introduction**

- (1) Child care providers are allowed a deduction for expenses associated with the business use of their homes. The requirements for the deduction are different than those for other businesses since qualifying usage does not require exclusive use for business. Regular usage is generally qualifying. A provider may have a combination of exclusively used rooms and regular used rooms, which is discussed in the instructions of Form 8829. See IRC Section 280A(c)(4).
- (2) If the child care provider meets the requirements to qualify to take the deduction (discussed below), it is computed on Form 8829, Expenses for Business Use of Your Home.

### **B. Requirements to Qualify for Business Use of Home Deduction for Day Care Facilities (Regulatory)**

- (1) In order to claim the business-use-of-the-home deduction, the taxpayer must meet the following two requirements:
  - The provider must be in the trade or business of providing day care for children, persons age 65 or older, or persons who are physically or mentally unable to care for themselves. (IRC Section 280A(c)(4)(A)).
  - The provider must have applied for, been granted, or be exempt from having, a license, certification, registration, or approval as a day care center or as a family or group day care home under state law. The provider does not meet this requirement if their application was rejected or the license or other authorization was revoked. (IRC Section 280A(c)(4)(B)).
- (2) The examiner should check the requirements of the state in cases where the provider claims exemption from the state licensing requirements.
- (3) **Note to Examiners:** The licensing requirement applies only to the deduction for business use of the home. An unlicensed provider may still deduct other business expenses, such as food, toys, supplies, etc.

### C. Limitation on Deduction (Regulatory)

- (1) IRC Section 280A(c)(5) limits the deduction if the taxpayer's expenses exceed gross income from the child care activity. See IRC Proposed Regulation 1.280A-2(i) attached as Exhibit B for more details.

### D. Regular Use Versus Exclusive Use

- (1) The qualifications for business-use-of-the-home expenses are different for child care providers than for other businesses. Unlike most businesses, qualifying usage does not require exclusive use; however, Congress did impose a regular basis usage test in IRC Section 280A(c)(4) for the child care providers. In *Uphus v Commissioner*, T.C. Memo. 1994-71, the issue of regular use was addressed. This case discussed the regular basis usage test imposed by Congress in the law. The court stated: "Consistent with the Senate report, we have found that regular basis test is met where the taxpayer is able to establish that the business use is continuous, ongoing or recurring. ...However, where the business use of the area is merely an incidental or occasional business use, expenses incurred for that area are not deductible."
- (2) Revenue Ruling 92-3 provides specific guidance for the calculation of the deduction for the business use of a home by day care providers. In determining whether a space in the home passes the "regular use" test in computing business use of the home, Revenue Ruling 92-3 outlines the following:
- (3) If a room is available for day care use throughout each business day and is regularly used as part of A's routine provision of day care (including a bathroom, an eating area for meals or a bedroom used for naps), the square footage of that room will be considered as used for day care throughout each

business day. A day care provider is not required to keep records of the specific hours of usage of such a room during business hours. Also, the occasional non-use of such a room for a business day will not disqualify the room from being considered regularly used. However, the occasional use of a room that is ordinarily not available as part of the routine provision of day care (e.g., a bedroom ordinarily restricted from day care use but used occasionally for naps) will not be considered as used for day care throughout each business day.

## E. Determining Business Percentage

- (1) The business percentage consists of two elements: the space percentage and the time percentage discussed in detail below. The two percentages are multiplied by each other to get the business percentage. Part I of Form 8829, Expenses for Business Use of Your Home, walks you through the actual computation. The Form 8829 instructions provide detailed computation directions for the cases where the provider's business usage consists of a combination of exclusively-used rooms and regularly-used rooms.
- (2) **Note to Examiner:** Since there are no set norms, the examiner must establish the facts and circumstances in each case to determine the elements that go into making up the business-use-of-the-home percentage, discussed in more detail below, including the total square footage of the house and the business-use portion. The initial interview is essential to gather the facts, especially the room(s) that are used regularly or exclusively or both.
- (3) Space Percentage (Form 8829 Part I lines 1-3)
- (4) The space percentage consists of the area regularly used for business (the numerator) divided by the area of the complete home (the denominator). Square footage is a common measurement tool; however, any other reasonable method can be used if it accurately reflects the business percentage.
- (5) The examiner should ask the provider how each room included in the business area was used. Evaluate whether each room included was regularly used, as discussed above. Use follow-up questions as needed. If the regularly used test is met, that area is included in the numerator. Many times we tend to be judgmental in our analysis. Be careful to stick to the facts to determine whether a particular room was regularly used for business purposes. For example, the taxpayer has three children in his/her care and three bedrooms which are used for naps. The provider explains that the children are put down for naps separately since they sleep better. While the provider could put all three children down for naps in the same room, the examiner should not limit the deduction to the use of one bedroom. On the other hand, if the taxpayer is claiming the square footage of a formal dining room in the business usage and your interview indicates that the children have their meals in the kitchen, you will need to probe to determine exactly how the dining room is used on a continuous, ongoing, or recurring basis.

- (6) The examiner will need to determine the total square footage of the home. This can be done in several ways, such as reviewing house plans, blueprints, escrow papers, or any other documents that substantiate the square footage. A common error made by taxpayers is to include only one floor in the total square footage. For example, the taxpayer operates a day care facility on the main floor of her 1800 square foot home. She used 1800 as the total square footage. However, her home has a full basement. The basement square footage must be added to the total square footage. Another common error occurs in cases where the taxpayer is using the garage in the business. You must be sure that the square footage of the garage is added to the denominator (total home space) as well as the numerator (business usage space).
- (7) Time Percentage (Form 8829 Part I lines 4-6)
- (8) The time percentage is the total number of hours the facility was used for the child care business during the year (the numerator) divided by the total hours in the year (8,760 hours). The provider should record how the total hours the facility was used, was computed. Hours spent cooking, cleaning, and preparing activities for the business of child care could be included in the calculation of the numerator of the time percentage if the tests for deduction under IRC Section 162 (ordinary and necessary expenses) are otherwise met under the facts of the particular case. As illustrated in Revenue Ruling 92- 3, one hour is added to the 11 hours of actual day care operation for the ½ hour before and ½ hour after regular hours spent preparing for and cleaning up after the children.
- (9) **Note to Examiners:** The Revenue Ruling example is not an absolute rule. The time outside of the regular hours to be added can be more or less depending on the facts and circumstances in each case, which need to be evaluated in line with Section 162 (ordinary and necessary expenses). Some providers, because of the type of service provided and/or ages of the children, might spend more time preparing activities for the children than others and vice versa. In addition, some preparation work might be done on the weekends. Recordkeeping time can also be included. Often a provider will keep a detailed log of his/her activities for a significant part of the year. This detailed record keeping of the time spent and tasks performed is essential to provide the details needed by the examiner to make an informed determination under Section 162, so it is highly recommended that all providers keep such logs. Ultimately, examiners should make a decision based on the facts and circumstances of each case.

## F. Figuring the Allowable Deduction

- (1) Continuing on Form 8829, you will need to determine which expenses are direct and which are indirect. Direct expenses are those that are incurred exclusively for the business and provide no personal benefit. Indirect expenses are those that are not incurred exclusively for the business (i.e., expenses which benefit both the business and the home). Indirect expenses must be allocated using the business use percentage. The portion of mortgage interest and property taxes not deductible on Form 8829 should then be reported on Schedule A.



Verify any necessary entries to the source documents, especially the total mortgage interest and taxes claimed on Form 8829 and Schedule A, since it is a common error that these expenses are either duplicated or that more than 100% is deducted between the two schedules.

## **G. Tax Exempt Income Used for Payment of Housing Used in Day Care**

- (1) In some cases, providers may operate their day care businesses in housing that is provided by an employer as a nontaxable benefit. The most common instances involve military personnel and the clergy.
- (2) Military personnel receive tax-free housing as a condition of their employment. See IRC Section 134. The structure of the housing arrangement can vary between branches of the military and from base to base. Some bases provide government-owned housing where the only out-of-pocket costs may be cable and Internet expenses. On other bases, housing is privatized. Military personnel receive the nontaxable allowance in their monthly checks and are responsible for paying the rent and utilities directly to the housing contractor. It is possible that the amount of rent and utilities could exceed the housing allowance. Military personnel may also live off base in privately owned housing. They may use the nontaxable housing allowance to pay for rent and utilities or to make their house payment if they own a home.
- (3) A member of the clergy may receive a nontaxable housing (parsonage) allowance. See IRC Section 107 and Publication 517 for more details on the requirements for the allowance to be nontaxable.
- (4) IRC Section 265(a)(1) disallows otherwise allowable deductions for expenses attributable to the business use of the home to the extent that such expenses are allocable to tax- exempt income. The courts have stated that the legislative purpose behind IRC Section 265 is to prevent taxpayers from reaping a double tax benefit by using deductions attributable to tax-exempt income to offset taxable income. See *Induni v. Commissioner*, 98 T.C. 618, 621 (1992), *aff'd*, 990 F.2d 53 (2d Cir. 1993). Thus, for example, expenses incurred to maintain the home (deductible under IRC Section 162), casualty losses suffered due to the partial or complete destruction of the home (deductible under IRC Section 165(c)(1)), state and local real property taxes (deductible under IRC Section 164(a)), and depreciation of the home (deductible under IRC Section 167) are subject to the Section 265 limitation. However, under IRC Section 265(a)(6), the recipient of a tax- exempt military housing allowance or a parsonage allowance may deduct the full amount of otherwise deductible mortgage interest and real property taxes.
- (5) In determining the amount of business expense properly deductible in the event (1) a tax- exempt military housing allowance or a parsonage allowance is received, and (2) the home is used for the business of providing child care, the methodology described in Revenue Ruling 92-3 should first be applied to each

type of deductible expense. The business portion of the mortgage interest and real property taxes so determined should be claimed on the Form 8829 with the balance claimed on Form 1040, Schedule A (assuming itemized deductions are used). All remaining deductible expenses relating to the business use of the home should then be multiplied by a fraction, the numerator of which is the tax-exempt housing allowance and the denominator of which is the total amount of the deductible expenses relating to the business use of the home (e.g. the total amount of the mortgage interest, real property taxes, depreciation, and maintenance expenses). The resultant amount is the amount to be disallowed.

(6) The effects of this formula may be shown as follows.

- The taxpayers receive a \$6,000 housing allowance and their housing expenses total \$7,000, of which \$4,000 is property taxes and mortgage interest and \$3,000 is other expenses of maintaining the home (including \$500 for house depreciation allocable to the business use of the home for the child care activity). There is a 30-percent time and space use allocation of the home to the child care activity. The deductibility of the property taxes and mortgage interest is unaffected by IRC Section 265. Accordingly, the normal allocation required by IRC Section 280A should be performed. So, 30 percent of the \$4,000 in property taxes and mortgage interest, or \$1,200, should be reported on Form 8829 as allocable to the child care business. The remaining \$2,800 should be reported on Schedule A in the appropriate categories.
- An allocation of the remaining \$3,000 of expenses is required by IRC Section 265. First, determine the amount attributable to the child care activity by multiplying 30 percent by those house expenses other than house depreciation (\$2,500), which equals \$750. Then calculate the amount of house depreciation that would normally be allowed if fully claimed on Form 8829 (\$500) and add this to the business portion of the remaining expenses (\$750) equaling \$1,250. Next, \$6,000 of the total \$7,000 housing expenses is allocable to the housing allowance. Thus  $\frac{6}{7}$ 's of the \$1,250, or \$1,071.43, cannot be allowed as a deduction by virtue of IRC Section 265. This leaves only \$178.57 of the additional housing expenses that are deductible on Form 8829.

(7) **Note to Examiners:** Ask in your interview if a nontaxable housing allowance is an issue. The military does not put the nontaxable housing allowance on the Form W-2, hence if it is an issue, you will need to look at the pay stub, which will list the amount of the allowance.

## G.1. Depreciation of the Home

- (1) This only applies to the residence building and not to the value of the land, equipment or other depreciable assets. To determine the depreciable basis, use the lesser of (1) cost or other basis of the home, or (2) the fair market value on the date the property was placed in service for business purposes.

## G.2. Modifications to the Home

- (1) Expenses incurred to modify a residence should be treated as capital expenditures even if it is to comply with licensing requirements. A capital expenditure includes any amount paid for permanent improvements or modifications that have a useful life that extends beyond the tax year and which is made to increase the value of the property. These types of improvements are generally depreciable.

## G.3. Sale of Home

- (1) A capital gain issue may arise if the provider/owner sells the residence (home) in which he or she operated a business and depreciation deductions were allowed or were allowable. All or a portion of the gain on the sale of the home may qualify under IRC Section 121 to be exempt from taxation if the provider meets certain requirements discussed below. However, IRC Section 121(d)(6) provides that the exclusion provided under IRC Section 121 does not apply to any gain from the sale of a principal residence attributable to depreciation adjustments (as defined in IRC Section 1250(b)(3)) allowed or allowable for periods after May 6, 1997. Therefore, a provider/owner who used part of his or her home for business purposes may not exclude any gain from the sale of that residence that is attributable to depreciation adjustments taken or allowed for periods after May 6, 1997.
- (2) If the business is conducted within the primary residence structure, then the gain, except for depreciation allowed or allowable, can be excluded if the provider/owner meets certain requirements, including the time and ownership test discussed below. If the business is conducted in a structure separate from the personal residence, then the portion of the gain allocable to that structure would not qualify under Section 121 for exclusion unless the provider/owner can show personal use of the structure that meets the time and ownership test. An allocation between the separate business use structure and the personal residence structure is required. (IRC Regulation 1.121-1(e) and Publication 523 provide more information and examples relating to this issue.)
- (3) Time and Ownership test: Even if property is used exclusively as the provider's principal residence in the year of sale, the provider is not necessarily entitled to the exclusion under IRC Section 121. To qualify for the full exclusion, the provider must have owned and used the property as his principal residence for at least 2 years during the 5-year period immediately preceding the sale. If the provider does not meet the 2-year requirement, then a portion of the exclusion will be allowed if the sale is made under the circumstances described in IRC Section 121(c).

### XIII. Toys

- (1) This can be a significant expense depending on the size of the operation. Some toys may be depreciable while others may be deductible. Refer to IRC Sections 167, 168, and 179 and Publication 946, How To Depreciate Property, for information on this distinction. Examine this item for large, unusual, questionable, and personal items.

### XIV. Advertising

- (1) Advertising is usually a minimal deduction for the “kith and kin” care providers and family child care operations. Usually the program sponsors or agencies provide free referral services.
- (2) Child care centers usually advertise in telephone directories, local newspapers, church bulletins, flyers, etc.
- (3) **Note to Examiner:** Use the RGS lead sheet for the audit steps.

### XV. Bad Debts

- (1) A “cash method” taxpayer should not have a bad debt expense. An “accrual method” taxpayer may have bad debts generated by nonpayment for services provided.
- (2) Follow normal procedures to substantiate the expense and the efforts to collect. Also, ask if the child is still in the program. If so, why is it a bad debt and was it subsequently collected?
- (3) **Note to Examiner:** Use the RGS lead sheet for the audit steps.

### XVI. Commissions and Fees

- (1) Fees paid to contractors for such things as landscaping, repairs, etc. are common among larger facilities and may be present in smaller sized providers. Filing of Forms 1099 Misc. for the work performed by the contractor may be required based on the amount the provider paid, and failure to issue the forms may be an issue and may result in the assessment of penalties (See IRC Section 6041 and Instructions for Form 1099).
- (2) Whether the expense is an ordinary and necessary expense per IRC Section 162 and what business use percentage is applicable depends on the facts and circumstances in each case. Providers whose businesses are located in a separate facility apart from the personal residence do not pose the same challenges.
- (3) A potential employment tax issue can be found in this type of business where “employees” are being treated as independent contractors. See the discussion below under wages and compensation.
- (4) **Note to Examiner:** Use the RGS lead sheet for the audit steps

## XVII. Employee Benefit Program/Pension and Profit Sharing

- (1) There are numerous employee benefit programs available, some of which are medical, disability and other accident or health plans described in IRC Sections 105 and 106; group term life insurance coverage described in IRC Section 79; coverage under a dependent care assistance program described in IRC Section 129; coverage under an adoption assistance program described in IRC Section 137, and coverage under an IRC Section 401(k) or other type of retirement plan. More sophisticated and/or complex child care providers might offer more benefit plans than smaller providers, while many others might have none. This can be a complicated issue. Follow local procedures to determine if a referral is necessary. See appropriate publications for further information on benefit plans, including Publication 15-B, Employer's Tax Guide to Fringe Benefits, and Publication 560, Retirement Plans for Small Businesses.
- (2) **Note to Examiner:** Use the RGS lead sheet for the audit steps

### A. Insurance

- (1) This expense item normally includes general business liability coverage, workmen's compensation coverage for employees, casualty insurance for large assets used by the facility, and other property-related insurance costs. This does not include home owner's insurance, which is one of the expenses reported on Form 8829, Business Use of the Home.
- (2) Evaluate the nature of the insurance and the assets covered to determine what business use percentage should be applied to the cost to be deductible based on the facts and circumstances.
- (3) **Note to Examiner:** Use the RGS lead sheet for the audit steps

### B. Office Expenses and Supplies

- (1) The office expense and supply category can include numerous expenses, such as food (previously discussed), toys, diapers (often provided by the parents), office supplies, cleaning supplies, educational and art supplies, etc. If material, these categories should be examined to see if they include personal items or whether the business use percentage utilized is realistic based on the facts and circumstances of the case.
- (2) The provider should list large expenses separately under the "Other Expenses" category as well as keep records how they determined the business usage percentage. Some items such as cleaning supplies, the business use of the home percentage would be appropriate to use while other expenses should use an actual usage method percentage such as computer related supplies would use the computer business usage percentage. If the expense is material, records on usage should be maintained to avoid areas of controversy.

## **C. Rent**

- (1) Rental expenses should be allocated according to the business use percentage. If the rental is for the personal residence, see “Business Use of Home” section above.

## **D. Start-Up Costs (paid or incurred after October 22, 2004)**

- (1) Start-up costs are expenses the taxpayer incurs prior to opening the business that would ordinarily be deductible if the business was open and active. These include licensing fees, advertising costs, inspection fees, supply expenses, pre-opening payroll expenses, professional fees, and other miscellaneous expenses paid or incurred prior to the opening day. Depreciation on assets purchased prior to the opening day begins on the opening day or the day upon which the asset is actually placed in service after opening day. Start-up expenditures cannot be deducted as a current expense. However, the taxpayer may elect in the year the business opens to deduct \$5,000 (or the amount of the actual start-up expenses if less) and amortize the remaining expenses ratably over the 180-month period beginning with the month in which the active trade or business opens. If the total start-up expenses exceed \$50,000, then the \$5,000 deduction allowed is reduced by the amount by which the expenses exceed \$50,000. Effective for expenses incurred or paid after Sept. 8, 2008, per IRC Regulation 1.195-1T a taxpayer is deemed to have made the election to expense and amortize the start-up costs unless the taxpayer clearly elects to capitalize them on a timely-filed federal Income tax return (including extensions) for the year in which the trade or business becomes active (begins). Taxpayers may apply the new regulations to expenses paid or incurred after Oct. 22, 2004, by filing amended returns, provided the statute of limitations has not expired.
- (2) Reference: IRC Section 195; Publication 535

## **E. Organizational Costs of Corporations or Partnerships (paid or incurred after October 22, 2004)**

- (1) Organizational costs paid or incurred to create a corporation or partnership may be deducted in the same manner as start-up costs for a sole proprietorship. Effective for organizational expenses incurred or paid after September 8, 2008, per IRC Regulations 1.248-1T and 1.709-1T, a taxpayer is deemed to have made the election to expense and amortize the organizational costs unless the taxpayer clearly elects to capitalize them on a timely-filed federal Income tax return (including extensions) in the year in which the trade or business becomes active (begins). Taxpayers may apply the new regulations to expenses paid or incurred after Oct. 22, 2004, by filing amended returns, provided the statute of limitations has not expired.

- (2) Reference: See IRC Sections 248 and 709 and Publication 535 for more details.

## **F. Telephone Expense**

- (1) Recommend removal as code has changed and representation is not supported.

## **G. Utilities**

- (1) The cost of utilities is generally an allowable expense. For facilities located in the personal residence, this is an expense includable in the business-use-of-the-home deduction (Form 8829) discussed above. For facilities that are located separate and apart from the residence, utilities should be listed on the Schedule C line for that expense.

## **H. Bank Charges**

- (1) Bank charges are allowable for a separate business account. For a combined business/personal account, bank charges are allowed to the extent of the business percentage.

## **I. Gifts**

- (1) Under IRC Section 274(b)(1), the deduction for gifts to the children or their parents are limited to \$25 per person per year and must meet the recordkeeping requirements of IRC Section 274(d). and IRC Regulation 1.274-5T. See also Publication 463. Examiners should not confuse expenses related to activities done with the children with gifts.

## **J. Other Expenses**

- (1) The "Other Expenses" category may be used to deduct expenses separately identified on the return, such as food, toys, gifts, etc.

## **K. Wages/Compensation**

- (1) Child care providers may have people who work for them either part-time or full-time. Larger providers, such as child care centers, may have directors, assistant directors, teachers, assistants, cooks, drivers, etc. These workers are generally considered employees. Wages for these people are deductible and normal employment taxes apply.
- (2) Family members may work as employees of the business if bona fide services are performed. It is recommended for family member that the provider keeps a record of the dates, time, compensation rates, and work performed that clearly establishes the business purpose and to establish the bona fide service aspect. See Publication 15 for related employment tax details.

- (3) If the child care provider is a sole proprietorship, then the payments made to the provider are considered “draws” and are not deductible under wages or any other category.
- (4) Partnerships are flow-through entities. Payments to the partners are not deductible by the partnership in determining net income unless they are guaranteed payments. Guaranteed payments and the net income allocated to each partner are usually subject to self-employment tax. If the provider is organized as a corporation or an S corporation, then the payments taken by the shareholders who perform services for the entity are wages subject to employment tax and deductible as wages.

## **XVIII. Employee Versus Independent Contractor**

- (1) Note to Examiner: If you have a potential employment tax issue or a worker reclassification issue, refer the issue to the Employment Tax Specialty Group to work. The discussion below is included to help you identify this issue in your case.
- (2) The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification-- independent contractor or employee -- can be valid.
- (3) The first step in any case involving worker classification is to consider Section 530 of the Revenue Act of 1978. Before or at the beginning of an audit inquiry relating to employment status, an examiner must provide the taxpayer with a written notice of the provisions of Section 530 (Publication 1976). If the requirements of Section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the business's, but not the worker's, employment tax liability, including any interest or penalties attributable to the liability for employment taxes.
- (4) In determining a worker's status, the primary inquiry is whether the worker is an independent contractor or an employee under the common law standard. Under the common law, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency -- whether one party, the principal, is legally responsible for the acts or omissions of another party, the agent -- and depends on the principal's right to direct and control the agent.
- (5) Guidelines for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations: Sections 31.3121(d) -1, 31.3306(i) - 1, and 34.3401(c) -1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding. The regulations provide that an employer-employee relationship exists when the business for which the services are performed has the right to direct and control the worker who performs the services. This control refers not only to the result to be accomplished by the worker, but also to the means and details by which that



result is accomplished. In other words, a worker is subject to the will and control of the business not only as to what work shall be done, but also how it shall be done. It is not necessary that the employer actually direct or control the manner in which the services are performed if the employer has the right to do so. To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined.

- (6) The Service now looks at facts in the following categories when determining worker classification: behavioral control, financial control, and relationship of the parties.
- (7) Behavioral Control: Facts that substantiate the right to direct or control the details and means by which the worker performs the required services are considered under behavioral control. This includes factors such as training and instructions provided by the business. Virtually every business will impose on workers, whether independent contractors or employees, some form of instruction (for example, requiring that the job be performed within specified time frames). This fact alone is not sufficient evidence to determine the worker's status. The weight of "instructions" in any case depends on the degree to which instructions apply to how the job gets done rather than to the end result.
- (8) The degree of instruction depends on the scope of instructions, the extent to which the business retains the right to control the worker's compliance with the instructions, and the effect on the worker in the event of noncompliance. The more detailed the instructions that the worker is required to follow, the more control the business exercises over the worker, and the more likely the business retains the right to control the methods by which the worker performs the work. The absence of detail in instructions reflects less control.
- (9) Financial Control: Facts on whether the business has the right to direct or control the economic aspects of the worker's activities should be analyzed to determine worker status. Economic aspects of a relationship between the parties illustrate who has financial control of the activities. The items that usually need to be explored are whether the worker has a significant investment, whether the worker has unreimbursed expenses, whether the worker's services are available to the relevant market, whether the worker is paid by the hour as opposed to a flat fee for the services performed, and whether the worker has the opportunity for profit or loss. The first four items are not only important in their own right but also affect whether there is an opportunity for the realization of profit or loss. All of these can be thought of as bearing on the issue of whether the recipient has the right to direct and control the means and details of the business aspects of how the worker performs the services.
- (10) The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of the services rendered. Significant investment, unreimbursed expenses, making services available, and method of payment are all relevant in this regard. If the worker is making decisions which

affect his or her bottom line, the worker likely has the ability to realize profit or loss.

- (11) Relationship of the Parties: The relationship of the parties is important because it reflects the parties' intent concerning control. Courts often look to the intent of the parties, which is most often embodied in contractual relationships. A written agreement describing the worker as an independent contractor is viewed as evidence of the parties' intent that a worker is an independent contractor, especially in close cases. However, a contractual designation, in and of itself, is not sufficient evidence to determine worker status. The facts and circumstances under which a worker performs services are determinative of a worker's status. The designation or description of the parties is immaterial. This means that the substance of the relationship governs the worker's status, not the label.
- (12) References: For an in-depth discussion, refer to Internal Revenue Manual 4.23.5, Technical Guidelines for Employment Tax Issues, which includes the Section 530 determination, and related exhibits. Publication 15B, Employer's Supplemental Tax Guide, is also available to provide guidance.

## **XIX. Exhibit A Sample IDR**

- (1) Shown below are items examiners may want to consider when preparing an Information Document Request (IDR) for a child care provider.
- (2) NOTE: While the list is not all inclusive, at the same time not all items should be requested in every case. Examiners should use this information as a guide and request only the items that are appropriate and relevant for their specific cases.
  - Be prepared to discuss the business history of your child care activity, including the starting date, a brief description of a typical day's activities, rooms used on a "regular" basis, and internal controls for income and expense information.
  - If you are taking any deductions for the use of your home in your child care activity, provide a floor plan, blueprint, or other relevant documents that reflect the square footage of the residence. Provide the escrow and/or closing statement to verify the cost of the property. Provide mortgage company statements or other relevant documents that show the property taxes and mortgage interest paid during the taxable years (insert the taxable years). If you are renting your home, provide substantiation of the rent paid during the taxable years (insert the taxable years) and a copy of the rental agreement.
- (3) Provide copies of your federal income tax returns for the taxable years (insert the taxable years); prior federal and state tax audit reports for the taxable years (insert the taxable years); and any related tax returns (e.g., partnership returns, corporate returns, or employment tax returns) for the taxable years (insert the taxable years); and any Forms 1099 filed and/or received during the taxable years (insert the taxable years).

- (4) Provide journals, ledgers, records, and/or notebooks used to keep a record of your clients and the amount they paid (weekly, monthly, etc.) during the taxable years (insert the taxable years).
- (5) Provide all bank statements, business and personal, for the period beginning (insert first day of the period) and ending (insert last day of the period).
- (6) If you are a participant in a food program, provide copies of the reimbursement statements, name and address of the food sponsor, attendance and meal count record, and time record for reimbursements received during the taxable years (insert the taxable years).
- (7) Provide a copy of any benefit or retirement plan offered to your employees.
- (8) Provide substantiation in the form of canceled checks, receipts, statements, or invoices for expenses identified for examination.
- (9) Provide all business licenses, approvals, registrations, and certifications.
- (10) For the taxable years (insert the taxable years), provide any contracts for services, rate schedules, policy statements, sign-in/out sheets or any other attendance records, emergency contact sheets and/or medical treatment forms for children in program for year of examination, permission slips for trips, and year end statements to parents, if any.

## XX. Exhibit B Internal Revenue Regulation 1.280A-2(i)

### **(i) Proposed Regulation 1.280A-2 Deductibility of expenses attributable to business use of a dwelling unit used as a residence**

#### **(1) Limitation on deductions –**

(1) In general. The deductions allowable under chapter 1 of the Code for a taxable year with respect to the use of a dwelling unit for one of the purposes described in paragraphs (b) through (f) of this section shall not exceed the gross income derived from such use of the unit during the taxable year, as determined under subparagraph (2) of this paragraph. Subparagraphs (3) and (4) of this paragraph provide rules for determining the expenses allocable to the business use of a unit. Subparagraph (5) of this paragraph prescribes the order in which deductions are allowable.

#### **(2) Gross income derived from use of unit.**

- (i) Only income from qualifying business use to be taken into account. For purposes of section 280A and this section, the taxpayer shall take into account, in applying the limitation on deductions, only gross income from a business use described in section 280A(c). For example, a taxpayer who teaches at school may also be engaged in a retail sales business. If the taxpayer uses a home office on a regular basis as the principal place of business for the retail sales business (a use described in section 280A(c)(1)(A)) and makes no non-business use of the office, the taxpayer shall take the gross income from the use of the office for the retail sales business into account in applying the limitation on deductions. Even if the taxpayer also corrects student papers and prepares class presentations in the home office (not a use described in section 280A(c)), no portion of the taxpayer's gross income from teaching may be taken into account in applying the limitation on deductions
- (ii) More than one location. If the taxpayer engages in a business in the dwelling unit and in one or more other locations, the taxpayer shall allocate the gross income from the business to the different locations on a reasonable basis. In making this determination, the taxpayer shall take into account the amount of time that the taxpayer engages in activity related to the business at each location, the capital investment related to the business at each location, and any other facts and circumstances that may be relevant.

(iii) Exclusion of certain amounts. For purposes of section 280A(c)(5)(A) and this section, gross income derived from use of a unit means gross income from the business activity in the unit reduced by expenditures required for the activity but not allocable to use of the unit itself, such as expenditures for supplies and compensation paid to other persons. For example, a physician who uses a portion of a dwelling unit for treating patients shall compute gross income derived from use of the unit by subtracting from the gross income attributable to the business activity in the unit any expenditures for nursing and secretarial services, supplies, etc.

**Expenses allocable to portion of unit.**

The taxpayer may determine the expenses allocable to the portion of the unit used for business purposes by any method that is reasonable under the circumstances. If the rooms in the dwelling unit are of approximately equal size, the taxpayer may ordinarily allocate the general expenses for the unit according to the number of rooms used for the business purpose. The taxpayer may also allocate general expenses according to the percentage of the total floor space in the unit that is used for the business purpose. Expenses which are attributable only to certain portions of the unit. e.g., repairs to kitchen fixtures, shall be allocated in full to those portions of the unit. Expenses which are not related to the use of the unit for business purposes, e.g., expenditures for lawn care, are not taken into account for purposes of section 260A.

**Time allocation for use in providing day care services.** If the taxpayer uses a portion of a dwelling unit in providing day care services, as described in paragraph (f) of this section, and the taxpayer makes any use of that portion of the unit for nonbusiness purposes during the taxable year, the taxpayer shall make a further allocation of the amounts determined under subparagraph (3) of this paragraph to be allocable to the portion of the unit used in providing day care services. The amounts allocated, to the business use of the unit under this subparagraph shall bear the same proportion to the amounts determined under subparagraph (3) of this paragraph as the length of time that the portion of the unit is used for day care services bears to the length of time that the portion of the unit is available for all purposes. For example, if a portion of the unit is used for day care services for an average of 36 hours each week during the taxable year, the fraction to be used for making the allocation required under this subparagraph is  $36/168$ , the ratio of the number of hours of day care use in a week to the total number of hours in a week.

**Order of deductions.** Business deductions with respect to the business use of a dwelling unit are allowable in the following order and only to the following extent:

(ii) The allocable portions of amounts allowable as deductions for the taxable year under chapter 1 of

the Code with respect to the dwelling unit without regard to any use of the unit in trade or business, e.g., mortgage interest and real estate taxes, are allowable as business deductions to the extent of the gross income derived from use of the unit.

(ii) Amounts otherwise allowable as deductions for the taxable year under chapter 1 of the Code by reason of the business use of the dwelling unit (other than those which would result in an adjustment to the basis of property) are allowable to the extent the gross income derived from use of the unit exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph.

(iii) Amounts otherwise allowable as deductions for the taxable year under chapter 1 of the Code by reason of the business use of the dwelling unit which would result in an adjustment to the basis of property are allowable to the extent the gross income derived from use of the unit exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph.

Cross reference. For rules with respect to the deductions to be taken into account in computing adjusted gross income in the case of employees, see section 62 and the regulations prescribed thereunder.

Example. The provisions of this subparagraph may be illustrated by the following example:

Example. A, a self-employed individual, uses an office in the home on a regular basis as a place of business for meeting with clients of A's consulting service. A makes no other use of the office during the taxable year and uses no other premises for the consulting activity. A has a special telephone line for the office and occasionally employs secretarial assistance. A also has a gardener care for the lawn around the home during the year. A determines that 10% of the general expenses for the dwelling unit are allocable to the office, On the basis of the following figures, A determines that the sum of the allowable business deductions for the use of the office is \$1,050.

Note: The example in the regulation has been modified to keep the content while making the example accessible for visually challenged individuals to read and understand in the below table

Credit/Debit	Dollar amount
Gross Income from consulting service	\$1,900
Less Expense for secretary	\$500
Less Business telephone	\$150
Less Supplies	\$200

Credit/Debit	Dollar amount

Equal Total expenditures not allocable to use of unit	\$850
Gross income derived from use of unit (Gross Income less total expenses)	\$1,050
Deductions allowable under subparagraph (5) (i) of this paragraph:	
Mortgage interest (total \$5,000) allocable to office	\$500
Plus Real estate taxes (total \$2,000) allocable to office	\$200
Equal Amount allowable	\$700
Limit on further deductions (\$1,050 less \$700)	\$350
Deductions allowable under subparagraph (5) (ii) of this paragraph:	
Insurance (total \$600) allocable to office	\$60
Plus Utilities, other than residential telephone (total \$900) allocable to office	\$90
Plus Lawn Care (total \$500)	0
Equals Amount allowable	\$150
Limit on further deductions (\$350 less \$150)	\$200
Deductions allowable under subparagraph (5)(iii) of this paragraph:	
Depreciation (total \$3,200) allocable to office	\$320
Amount allowable	\$200

No portion of the lawn care expense is allocable to the business use of the dwelling unit. A may claim the remaining \$6,300 paid for mortgage interest and real estate taxes as itemized deductions.

Comment by Author of ATG: Lawn expense may be an allowable business expense for a child care provider - see section Introduction: determining the deductible amount under IRC Section 162 and the business usage. The taxpayer in the regulation is a business consultant and would not be allowed any lawn care expense.