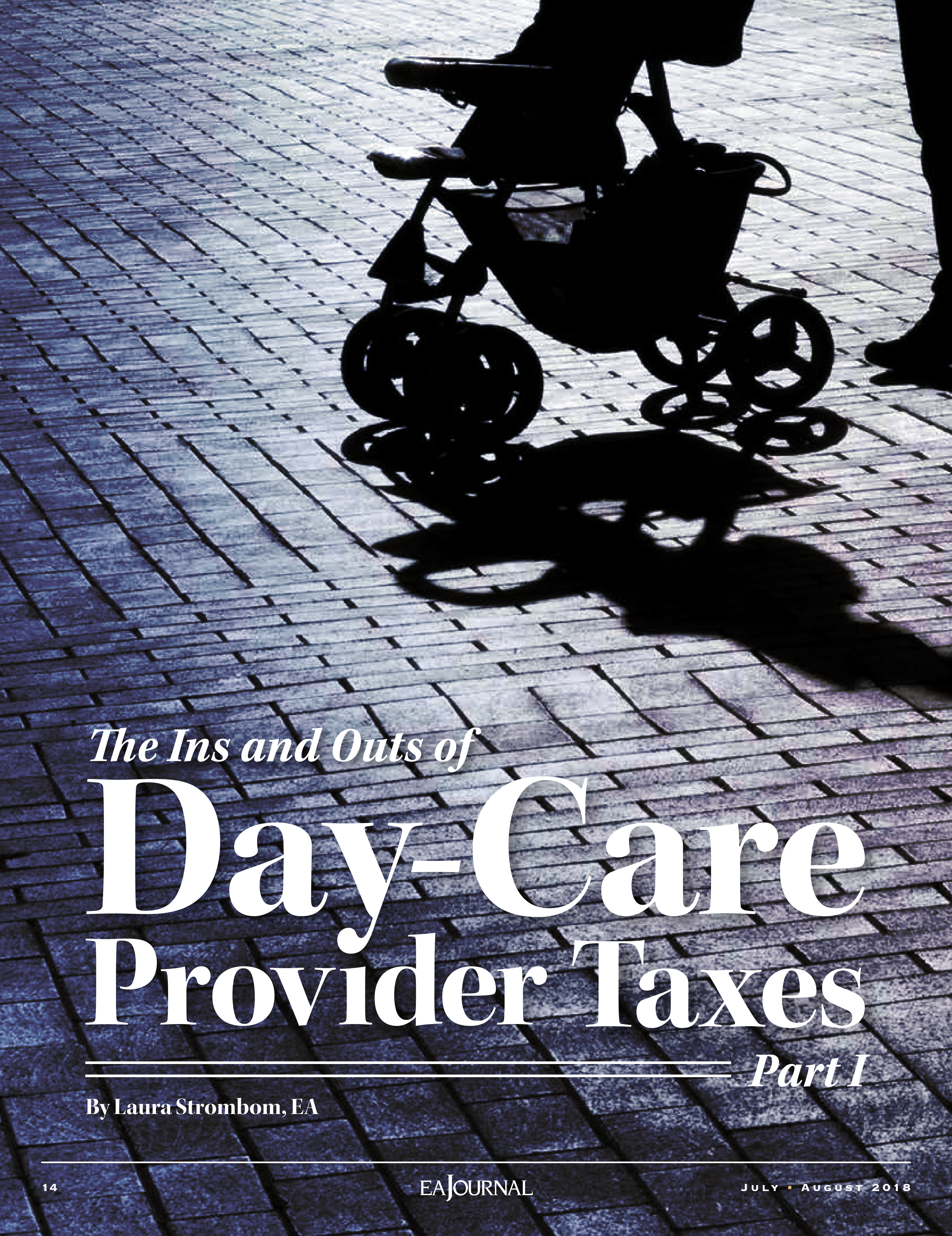

The Ins and Outs of Day-Care Provider Taxes
Part I

By Laura Strombom, EA

The Ins and Outs of

Day-Care Provider Taxes

As the profession adapts to the changes under the Tax Cuts and Jobs Act of 2017, those who prepare primarily basic returns, such as a 1040 with only a Schedule A, may need to add additional areas to their practices. One strategy is to specialize in an area that will continue to demand expert preparation services. Specializing in day-care tax preparation can lead to a profitable niche for the EA. It is not easy for taxpayers to accurately prepare a day-care tax return using commercial do-it-yourself software. Understanding what is allowed as a deduction is frequently unclear to them. In this two-part article, the reader should emerge well versed in everything day-care tax related.

An Introduction to DCP Tax Prep

Day-care provider (DCP) tax preparation requires specific knowledge of special provisions in the tax code for this type of business. These provisions include unique business-use-of-home rules and a standard meal allowance. In addition, many of these businesses have substantial mixed-use items—expenses that apply for both personal and business, such as the purchase of cleaning supplies. When a DCP return is audited, an unfamiliar auditor will often disallow many items that should be allowed; the IRS is aware of this. In fact the *Audit Technique Guide* for child-care providers states that "the examiner needs to evaluate in a fair and objective manner whether the expense is deductible under IRC Section 162."

Most often, a DCP is a sole proprietor, usually female, who provides services in her home to care for the children of others for less than 24 hours at time. In most states a license is required, although "kith and kin" care is usually exempted from license requirements. Kith and kin care is a situation in which the provider is caring for children belonging to no more than one family or all the children are related to the provider.

If a provider is required to have a license, but does not have one, the special business-use-of-home provisions cannot be used. Though day care for children is most common, adult day cares also qualify for the special tax treatments. In order to qualify, the adult day care must be less than 24 hours at a time provided to disabled adults or adults age 65 or older.

Schedule C

Because a DCP offers a service for which others take a tax credit, the DCP shares her tax-identification information with her clients. By default, this means she is supplying her SSN with her address on Form W-10 (Dependent Care Provider's Identification and Certification). In today's environment of identity theft, it is strongly advised that the DCP file Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding) to obtain an employer tax identification number (EIN) to give instead of her SSN. If the DCP has taken this step, it is important to list the EIN on Schedule C and to include the trade name as assigned to the EIN. She can obtain this number even if she does not have, nor does she ever intend to have, any employees.

The next item to be sure to address on Schedule C is using the correct business classification code. Too many returns for DCPs are prepared using code 999999 instead of the proper code—624410. This is important as the IRS compares historical statistics to returns using the same code number. Using the wrong code could result in inaccurate statistical variations, which are clarified through audit.

Moving down the Schedule C, the next notable section is the 1099 set of questions. This is a business, and 1099s should be filed as required by law. Often, DCPs will overlook issuing 1099s to gardeners, housekeepers, repair services, contractors, and others. Meanwhile, they will often want to issue 1099s to helpers or assistants they want to consider as "casual labor" or independent contractors instead of W-2s, which are more likely to be the appropriate form to file.

In both cases, the enrolled agent needs to educate the client. Often, when told about the steep penalties for intentionally failing to file 1099s, a DCP is willing to comply with the law. If she does not want to issue 1099s, a strategy could be to only make electronic payments using debit or credit cards. That way the electronic payment processor issues a 1099-K (Payment Card and Third Party Network Transactions) and the DCP is relieved of this requirement. Using PayPal or other similar services for those who do not accept credit cards could facilitate this strategy.

Next is Part I, which is the income section of the return. IRC §61 states that all gross income must be reported. For a DCP, this includes payments directly from clients, subsidized payments from welfare or social services agencies, grants, Child and Adult Care Food Program (CACFP) payments, and other reimbursement income. For elder-care providers, payments may come directly from long-term care insurance companies.

DCPs will sometimes barter with others. The value of the services provided by the DCP also needs to be included as income, even if the bartered service, such as pay for an assistant or the services of a gardener, is deductible. A client will often ask why this is so. Explaining to her that she needs to issue a W-2 to the assistant and pay payroll taxes on the amount, and then explaining a 1099 must be issued to the gardener, and that not all of the gardener's payment is a deduction will clear up the issue, though not to the liking of the client!

There are two lines to enter income on Schedule C. Line 1, gross receipts or sales, should include the income earned specifically for the services the business provides. This will include direct and subsidized payments, barter income, and any insurance payments for elder care. This figure should equal or exceed the sum of the 1099s received from agencies, 1099-Ks from electronic processes, and the amounts claimed as paid by clients on their taxes.

How does a DCP know what her clients are reporting on their taxes? There is an element of trust here. It is recommended that the DCP provide a statement each year to clients detailing amounts paid in addition to the other information required by the client to properly complete Form 2441 (Child and Dependent Care Expenses). Unfortunately, Form W-10 does not have a space to enter this figure. Many DCPs will modify the form using Adobe or other software so that they can provide this information on the form. Others will create their own form for this purpose to provide clients at year end.

Income from other sources, such as grants, CACFP payments, §179 recapture, and other reimbursements, would be reported on line 6, other income. This can be controversial as CACFP income is technically not taxed unless it is greater than the deduction. However, as we will discuss in the next installment, provided meals are a deduction. Because a deduction cannot be taken for an expense which has been reimbursed, it is clearer to report the income and then take the deduction.

Usually the deduction is greater than the income, so the net is a benefit to the taxpayer. Additionally, in the event of audit, if the auditor does not see food-program income reported, he or she will assume the food deduction is overstated and move to disallow it. When a taxpayer does not participate in the food program, it is often helpful to note this so that the meal expenses are not disallowed.

Additionally, a DCP might have interest on bank accounts. This information would not be reported on Schedule C, even if it is from a 100 percent business bank account. This is because interest income is not subject to self-employment tax. Be sure the taxpayer has not lumped this figure in with other earnings. Most taxpayers do not understand the differences. The EA will likely see a 1099-INT provided by the bank which paid the interest and properly include the interest on Form 1040 Schedule B, so if the taxpayer does not break out her figures, income could be overstated.

Line 2, returns and allowances, is a good place to acknowledge any refunds or bounced client checks. If the return is selected for examination, the auditor will complete a bank-deposit analysis. This involves totaling all deposits into the bank accounts, and subtracting transfers between accounts and other amounts that can be identified as nontaxable income, such as an owner investment or loan proceeds. The auditor may not pick up the redeposit of a bounced check or catch a refund check the taxpayer paid. Of course this can only be claimed if the original deposit is included in income.

A DCP will have many expenses that are both allowable business expenses and excluded personal expenses.

In regard to Part II, expenses, IRC §162 states:

> In general, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business…

However, IRC §262 counters this:

> Except as expressly provided in this chapter, no deduction shall be allowed for personal, living or family expenses.

A DCP will have many expenses that are both allowable business expenses and excluded personal expenses. These become mixed-use expenses. How do you determine the business amount versus the personal amount of something like toilet paper? Anyone who has lived with small children knows kids either use way too much or not nearly enough! Does the DCP need to count rolls used by the household and then switch out rolls when providing care to then count those used by the kids? Though the provider could do this, and probably get the most accurate result, applying the time/space percentage is much easier.

Time/Space Calculations

The time/space percentage is the method of calculating business use of home for a DCP. IRC §280A(c)(4) allows for this calculation. As the name implies, a calculation involving the time the home is used as a day-care facility as well as the portions of the home used all or in part by the business operations is made. This is unique as all other businesses operated in homes are held to the "regular-and-exclusive-use" standard.

The time aspect requires the provider to track the hours in which she has children present, not the hours she is willing to have children in her home. However, in addition to hours with children, she is also permitted to include hours used for other business purposes. This includes time spent doing administrative and cleaning business activities. Such activities include:

- business telephone calls
- laundering of linens and other items used in the business
- cleaning areas of the home used in the business
- email/internet activity

- client or prospective client meetings in the home
- food program tracking
- meal planning and meal preparation
- planning and preparing activities
- recordkeeping
- bookkeeping
- any other time spent relevant to the business that happens in the home

Time spent by a paid employee or service provider, such as a housekeeper, still counts as the home being used in a business activity. A DCP may think of this time as additive. If she has children 12 hours in a day, and during those 12 hours she spends 4 hours doing the aforementioned activities either herself or with the help of another person, this does not mean 16 hours is counted. The time is any time in which at least one of the business activities is happening.

Adding time can result in the DCP stating she spent more hours than there are in a year performing care activities! It is important to make sure the DCP is remembering to subtract days the business was closed due to illness, vacation, holiday, or other activity as well.

The calculation for this step is hours used in the business for the year divided by 8,760, the number of hours in a year. For a leap year, there are an additional 24 hours in the year. If the business began or closed during the year, the number is adjusted to the number of hours in the year the business was operational. Thus, if someone ended her business November 30, 31 days in December times 24 hours per day (744) would be subtracted from the 8,760, resulting in a new denominator of 8,016. This calculation gives the time percentage. *See the worksheet at right.*

One part of the space calculation involves measuring the areas where mixed use of business and personal activities happen, such as the kitchen, family room, living room, laundry area, etc. The square footage of the mixed-use areas are added together and divided by the sum of the total square footage of the home. Use caution when including areas of the garage. This area is not considered a living area so it is not included in the stated square footage of the home in public records. If the garage is added to the space used (the numerator), the square footage of the garage must also be added to the square footage of the home (the denominator). Parking the car in the garage is not considered business use of home. Using the garage as a children's play area is business use. This calculation gives part of the space percentage.

The second piece of the space percentage comes from areas of the home used exclusively for business purposes. This might include a bedroom converted into a classroom or nap room, an office that truly is

Time/Space Percentage Worksheet

A) TIME
a) Total hours with children during the year: ____________________
b) Total business hours without children during the year: ____________________
c) Total business hours (a + b): ____________________
d) Time percentage (c ÷ 8760): ____________________

B) SPACE – EXCLUSIVE USE
a) Total 100% exclusive-use areas: ____________________
b) Total square footage of home: ____________________
c) Total exclusive use (a ÷ b): ____________________

C) SPACE – MIXED USE
a) Total area of home used for both business and personal: ____________________
b) Total square footage of home: ____________________
c) Total mixed use (a ÷ b): ____________________

D) TIME/SPACE PERCENTAGE
a) Time (A) x Mixed Use (C): ____________________
b) Exclusive use (B): ____________________
c) Total time/space percentage (a + b): ____________________

EXAMPLE FOR TIME/SPACE PERCENTAGE
Sue operates a day care in her 2,000 square foot home. One thousand square feet are exclusively used by the day care only. This includes the living room permanently set up as a classroom (complete with white board and classroom décor,) bedrooms used as play areas, an office used 100 percent for the administrative business of the day care, and a bedroom set up just for napping. Of the remaining square feet, 800 are utilized for business and personal use. This includes a bathroom, the kitchen, an eating area, and the family room where the children watch TV. The only area of her home never used for day care is her master bedroom and bathroom. Sue has no children of her own living at home. Sue has counted 4,380 hours as her day-care time hours for the year.
- Time percentage (A) for Sue will be 4380/8760 = 50%
- Exclusive-use space percentage (B) for Sue will be 1000/2000 = 50%
- Mixed-use percentage (C) for Sue will be 800/2000 = 40%
- Percentage B + (Percentage A x Percentage C) = 50% + (50% x 40%) = 70%
- Seventy percent is the time/space percentage allowed for her business use of home expenses on Form 8829.

used exclusively for the business and administrative activities of the business as opposed to the activities of the whole household, or a bathroom retrofitted for kids with child-size toilets, lower sinks, a drinking fountain, and diaper-changing station. Such a bathroom should not be used by the family outside of business hours to qualify for the 100 percent exclusive-area use. The square footage of the exclusive-use areas are added up and divided by the square footage of the home.

There are three percentages to calculate: time, exclusive-use space, and mixed-use space. The time percentage is multiplied by the mixed-use space percentage. The exclusive-space percentage is then added to the total to arrive at the complete time/space percentage result.

The time/space percentage is applied to house expenses on Form 8829 (Expenses for Business Use of Your Home). However, it can also be very helpful to use for other items on Schedule C which have mixed use, such as the aforementioned toilet paper example. Other mixed-use items include consumables, such as cleaning supplies, shared-use assets such as furniture and appliances, and other household items such as dishes.

Form 8829 is designed for the usual business use of home with regular and exclusive use requirements. To properly calculate the time/space percentage, it may be necessary to override the percentage in your software and attach a statement showing the math used to arrive at the figure. Some software programs will do this for you. Make sure you are aware of how your program works so that you can properly adjust the percentage for your client's benefit.

Most of the 8829 for a DCP is the same as it is for other types of businesses. Direct expenses, those which are only for the business, are still 100 percent allowable if the area for which the expense applies is exclusively used for the day care. Most expenses are indirect and apply to the entire home. There are, however, differences as to what is allowed. Most businesses are allowed to deduct only those indirect expenses which relate to the entire house such as mortgage interest and property taxes. They are not allowed to deduct expenses that do not apply to the exclusive-use area of the home, such as a repair to the kitchen plumbing.

Utilities for "regular" businesses do not include cable or satellite services unless the business can show a real business purpose to have such service pertaining to the home office. When a bundled service for home telephone, internet, and television is paid, a normal home business cannot take the entire expense. In this situation, a business is allowed only the part related to the internet in most cases. To be clear, the basic service of the first phone line into a residence is never deductible as it has been specifically identified as personal (IRC §262 (b)). Not even a DCP can take this expense in any part, even though she may be legally required to have such a phone line.

As more people eliminate wired home phones, this becomes a bigger issue as taxpayers will only pay the bill for the wired service because it is a required business expense, and they will not understand why they cannot take this deduction. The costs of premium services, such as caller ID and call waiting, are still deductible, subject to the business use. Thus, for a bundled service, the DCP cannot take all the cost; television and internet if used for business are allowed, but not the basic telephone service.

Exterior expenses for a DCP may be allowed, such as yard or pool service, provided the persons cared for use these areas; they become part of the mixed-use expenses. Certain expenses, such as playground equipment, tanbark, or sand for a play area and kiddie pools may be 100 percent deductible as a direct expense. However, if the taxpayer has children who also use these items, they are still indirect expenses and subject to the time/space percentage.

Mortgage Interest

Starting with 2018 taxes, mortgage interest will be limited to only acquisition debt and only on debt up to $750,000. This will be a challenge for many taxpayers, and DCPs are no exception. It can be helpful to determine if any mortgage interest could be traced as business interest. An election can then be made under §1.163-10T(e) to not treat that equity debt as mortgage interest and instead that portion of the interest would be taken on Schedule C as deductible interest. It is important to understand that this election is permanent.

Sometimes a DCP will have an additional rider on her homeowner's insurance policy for the day care. If the cost of this rider can be determined, this amount can be classified as a direct percentage or deducted directly on the Schedule C. Be sure to reduce the total paid for insurance by any amount allocated elsewhere on the return.

Home Depreciation

Home depreciation must be reported on Form 8829 for any owned home, and again, DCPs are not exempt. Because IRC §1016 requires the basis of a property to be adjusted at sale by the amount of depreciation allowed (actually claimed) or allowable (could have been claimed but was not claimed), properly taking the depreciation is a must. It is advisable to discuss this concept with the taxpayer to help her remember she must recapture this depreciation later when/if she sells the home. If you are her preparer when this happens, you will have all the information needed and can be sure she pays the correct tax. This can be a client retention selling point.

Home Improvements

Improvements made to the home can also qualify for deductions. A regular business would not be able to deduct a kitchen remodel, however a day care can, if the kitchen is used for business. This additional improvement would share the same time/space allocations. An improvement specifically for the day care, such as the costs to retrofit the bathroom for children mentioned previously, would be 100 percent deductible. Because these improvements are

Common Home Office Expenses

- **Mortgage Interest**
  - Same rules
- **Property Taxes**
- **Insurance**
  - Earthquake
  - Fire
  - Hurricane
  - Renter's
- **Rent**
- **Repairs/Maintenance**
  - Air filters
  - Pest control
  - Smoke detectors/batteries
  - Light bulbs
  - Carpet cleaning
  - Yard care
  - Pool care – if pool used by kids and permissible by law
  - Appliance repairs and services
  - Painting
  - Building repairs
- **Utilities**
  - Water
  - Trash
  - Sewer
  - Electricity
  - Internet
  - Cable/satellite TV service
  - Alarm service
  - Not first phone line
- **Other**
  - Bottled-water services
  - Small appliances/furniture
  - Any other whole-house time/space percentage items
- **HOA Dues**

capital in nature for home office use, they are still depreciated over 39 years, even if they are 100 percent deductible.

Home Office Deduction

To support the deduction of the home office, it is an excellent idea for the taxpayer to take and keep dated pictures of the various areas in the home in use. Pictures should be updated annually to support the continued use. Children swimming in the pool, playing in the backyard, napping in the exclusive-use nap room, learning in the exclusive-use classroom, watching educational television in the living room, and sitting at the kitchen table eating will all serve to show the allowable usage.

Having a detailed floorplan with areas marked as mixed, exclusive, or not used is also helpful. A common mistake made by DCPs is to not include the areas marked as "off limits" by a licensing authority. Often this will include the entire upstairs of a two-story home. However, an upstairs laundry area regularly used for laundering business-use items such as bedding, towels, aprons, and soiled clothing will still be allowed as mixed use. An upstairs home office used regularly and exclusively for business can also be counted.

On the flip side, a DCP who claims that 100 percent of the home is used for business should be prepared to explain how the master bedroom and bath are used for business and be able to show support for this claim. Pictures of a master bedroom filled with cribs and kids sleeping on the bed have proven quite useful in audit situations. Remind your client to document as much as possible.

An interesting situation can apply when a DCP return also includes tax-free housing. This happens most often when the care provider files a joint return with a member of the clergy or the military. IRC §265 requires expenses paid for with tax-exempt income to be disallowed, with the exception of mortgage interest and property taxes for military housing or a parsonage (IRC §265(a)(6)(A-B)). When there is tax-exempt income, additional calculations will be required to reduce the allowed deductions of housing expenses.

Of course, as with any other business claiming a home office deduction, the expenses are limited to the profit of the business. Mortgage interest and property taxes as related to the business can generate a loss, as these expenses are allowed whether or not there is a business. Other expenses in excess of profit are suspended until such time as there is a profit.

Conclusion

Now that portions of Schedule C, time/space percentage calculations, and business use of home have been covered, in part two we will dive into common DCP expenses, including meals, application of the codified economic substance doctrine to day-care providers, substantiation requirements, common issues of DCP returns, and highlights of some recent court cases involving DCP returns. **EA**

For Your Review

1. Which code section addresses limitations on deductions when tax exempt income is received?

A. 266
B. 265
C. 264
D. 263

2. The correct code to use for a family-care provider is:

A. 624110
B. 624410
C. 999999
D. 6421

*See page 39 for the answers.

About the Author

Laura Strombom, EA, MBA, NTPI Fellow,® is the owner of All About Numbers, in Stockton, California. Laura and her team serve more than 2,000 clients in tax preparation, resolution, bookkeeping, payroll, and related work. 2018 marks her twenty-third year in business. In addition to her practice, Laura teaches CE courses around the country for various organizations. Email her at laura@allaboutnumbers.com.

Ready to be an NTPI Fellow®?

Start your journey with Level 1 Online!

Purchase each class individually or save $70 by purchasing the complete package.

Level 1 Online of the National Tax Practice Institute™ (NTPI®) features all-new classes from the best instructors in tax representation, introducing tax practitioners to the fundamentals of representing clients before the IRS. Participants receive the exact same course materials as in person registrants receive. Once Level 1 Online is fully complete, attendees may register for NTPI Level 2 offered in Las Vegas this August or in Orlando this November.

Course	Instructor	CE
Overview of Representation	Kevin Huston, EA, USTCP	2
Engagement Letters	Kevin Huston, EA, USTCP	1
Introduction to Collections	Marc Dombrowski, EA	3
Non-filers	Claudia A. Hill, EA	1
Innocent Spouse	Claudia A. Hill, EA	1
Ethics for the Tax Practitioner	Frank Degen, EA, USTCP	2
Introduction to Examination	Alan Pinck, EA	4
IRS Notices	LG Brooks, EA	1
Introduction to Criminal Investigations	LG Brooks, EA	1
Transcripts and CSED Extenders	Clarice Landreth, EA	2
Introduction to Appeals	Tom Gorczynski, EA, USTCP	2
Communicating with IRS	LG Brooks, EA	2
Tax Research and Resources	Tom Gorczynski, EA, USTCP	2

REGISTER TODAY

Earn up to **24 CE**, including **2 Ethics CE!**

Visit **bit.ly/level1online** for course descriptions, speaker biographies, FAQs, IRS program numbers, and more.

NAEA NATIONAL ASSOCIATION OF ENROLLED AGENTS | POWERING AMERICA'S TAX EXPERTS®

NTPI NATIONAL TAX PRACTICE INSTITUTE