In part 1 of this series, which ran in the July/August issue of the *EA Journal*, income and business use of the home were addressed with regard to day-care providers (DCPs) and tax returns. This article will address expenses and deductions. Many Tax Court opinions state that tax deductions are allowed as a matter of legislative grace.
IRC Section 162, Trade or Business Expenses

Section 162(a) 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… .

In a home day care, many of the expenses have personal and business elements. The Audit Technique Guide for child-care providers (ATG for CC) states: 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. (emphasis added)

Often it seems examiners do not read this last sentence. Therefore, it is critical that you, the preparer and possible representative, understand what is allowed. Be prepared to go to bat for your client. Ask your client to make the process easier by keeping documentation as much as possible on everything. For many DCPs, this is a time-consuming and challenging practice and process. Remind them that the time spent on recordkeeping adds to the time percentage of the time/space deduction, as explained in part 1.

Because of the mixed-use nature of many expenses, providers need to be able to use some sort of method to support the business percentage of the deduction. The time/space percentage is generally a safe method to use. If the DCP chooses not to use the time/space percentage method, she should use a log or some other logical method that shows how she calculated the business percentage of a deduction.
Codified Economic Substance Doctrine
Section 1409(a) of the Health Care and Education Reconciliation Act of 2010 created a conjunctive economic substance test in the new $7701(o). The essence of this doctrine is to determine not just that an expense is ordinary and necessary, but that there is also an economic reason for the expense.

Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties contains a list of circumstances in Step 1 in which the doctrine is likely not applicable to DCPs as well as a second list which is likely to apply. Key points to keep in mind for child-care providers, who often want to be creative, are:

- Transaction must be at arm’s length with a third party.
- Transaction does not accelerate a loss or duplicate a deduction.
- Transaction must have a credible business purpose apart from federal tax benefits.
- Transaction has meaningful potential for profit apart from tax benefits.
- Transaction has a significant risk of loss.
- Tax benefit is not artificially generated by the transaction.
- Transaction is not outside the taxpayer’s ordinary business operations.

The application of this for the tax preparer is to think through the expenses the taxpayer might try to justify that have no business benefit. It is not uncommon for DCPs to take the mixed-use concept of expenses a little too far!

Section 274(d) and Regulation §1.274-5T
Section 274(d) requires certain expenses to be substantiated “by adequate records or by sufficient evidence corroborating the taxpayer’s own statement” in order to take a deduction for these special expenses.

According to Regulation §1.274-5T, these expenses include:

- Traveling away from home (including meals and lodging).
- Any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, including the items specified in §274(e).
- Gifts defined in §274(b).
- Any listed property (as defined in §280F(d)(4) and §1.280F-6T(b)).

Under 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 appropriate measures 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.
- The business purpose for the expenditure or use.

Substantiation records should be kept contemporaneously, i.e., near the time of the actual occurrence. Keeping the above guidelines in mind, common day-care expenses include a number of items.

Advertising
This includes anything used to attract new customers. Common examples are websites/web listings, Yellow Pages, shopping-cart ads, sponsorships of local children’s sports teams and related activities, Facebook ads, and promotional open-house events.

Car and Truck
Section 280F still applies, limiting vehicle depreciation percentages to DCPs. They do not get special treatment for the depreciation of vehicles.

Some DCPs will buy a separate vehicle (usually an SUV or minivan) for the purpose of transporting kids to and from school. The fact that the DCP may view the vehicle as 100 percent business use does not mean she does not need to keep records.

Mileage Records
It is strongly recommended that the DCP keeps a mileage log. Substantiation is required, as mentioned earlier, under §274 for expenses related to listed property, such as vehicles. Consider encouraging her to use an app or supply her with sample logs to use.

Mileage to and from the grocery store is largely disallowed as personal mileage; however, child-care providers will argue it is a business trip. The ATG for CC states deductions are allowable if they are primary for business and not deductible if primary for personal. The mileage, in order to be deductible, must be related to the primary trade or business.

The amount of personal versus business time is taken into account as well. If your client wants to take grocery store mileage, she should be able to support that this is a trip exclusively for the day care and provide alternative proof of personal grocery shopping trips. It is worth the extra time and expense to do this.

If a trip has multiple stops, the business stops are allowed, the personal ones are not. For example, a taxpayer travels from home to the education supply store, a distance of 6 miles. This stop is purely for business purposes. She then travels 5 miles to a hair salon for a cut and color, which is strictly personal. She finally travels back home, a distance of 9 miles. Allowed would be 12 miles—round trip from home to the education supply store and back.

In order for the mileage to be deductible, there must be a profit motive present. Transporting the children on a field trip might require an explanation to an auditor: How is the trip profit related? Is it profit related if the provider charges the parents the...
fees for admission? Perhaps it is profit related if the field trip is to a children’s museum or a zoo where the DCP has a plan for enriching the children through these activities. This situation might offer a competitive advantage and justify a slightly higher fee structure since the DCP is offering more than just “glorified” baby-sitting services.

The professional DCP will cringe at the mere suggestion that the business she operates is just baby-sitting. In today’s marketplace, in order to be full to capacity, and thus more profitable, many DCPs are looking for activities to differentiate themselves. In some states, DCPs are required to offer curriculum and enrichment activities for licensing.

Let’s circle back to the grocery store example for a moment. Is it a profit motive if the food is reimbursed? Perhaps. If the provider advertises she serves all organic foods, then this may allow her to charge a higher fee than the competition. This could be a viable profit motive, even if she is reimbursed as the reimbursement will likely not cover the additional cost of the all-organic menu.

Transporting children to medical appointments, school, or even to and from home could be abused. Are the children family who would be transported anyway? (Watch for this particularly in “kith-and-kin” situations.)

**Standard vs. Actual**

Either the standard mileage rate or the percentage of actual expenses method is allowed, which is the same as for any other business. Remember the following:

- Once the actual expenses method is used, it must be used for the remaining life of that vehicle.
- If the actual expenses method is used, make sure your taxpayer is reporting 100 percent of the expenses. Often, she will keep only gas receipts for fill ups at or near a business use.
- Both methods include elements of depreciation that need to be addressed upon disposition of a vehicle.

Because detailed recordkeeping is required for capturing 100 percent of all expenses related to all vehicles, and recording by vehicle is time consuming and not a strong suit of many DCPs, the standard mileage rate is usually the better method. Keeping track of all expenses on all vehicles, by the way, is to be able to prove the gas receipts, etc., went into car A (used for day care) while other receipts went into car B (not used for business).

In an audit situation, IRS could assume that all fuel is being reported for all vehicles as if it was used in the business vehicle, thus taking a larger expense than allowed. Always be prepared to show the personal expenses that are separate from the business so that an auditor will not unfairly allocate personal use to bona fide business expenses. To be clear, it is strongly recommended that the DCP keeps a mileage log on a per-vehicle basis.

Regardless of the method of deduction chosen, business-related parking fees, tolls, property taxes charged to the vehicle (some states have this), and the business percentage of the interest on a related car loan are deductible. If the vehicle is legitimately used in the business, with more than just incidental business use, garaging the vehicle could be used as part of the business-use-of-home calculations. Refer to part 1 of this article for more about how this would be calculated.

**Commissions/Fees**

Common commissions and fees a DCP will encounter include:

- bank fees (100 percent deductible if a separate business account. Allocate business percentages of monthly fees and specific charges for fees related to the business, such as bounced check charges.)
- merchant service fees (discussed under “Income” in part 1)
- fire inspection fees
- CPR classes (usually these are required for all persons who work with children)
- Live Scan fees (a finger print and background check system is usually required for all persons in the household over age 18, as well as all employees)
- membership dues to business organizations (e.g., child-care associations, local chambers of commerce, etc.)
- subscription fees for magazines or other periodicals related to the business
- field trip admission
- continuing education

**Field Trips**

Regarding field trips, there are several things to keep in mind. As mentioned in discussing mileage deductions for field trips, make sure there is a profit motive for the field trip. This topic is addressed in the ATG for CC. If the provider collects extra money for field trips, either count the income and the expense or count neither. Field trips to McDonald’s or similar restaurants do not
have a cost if they are using standard meal rates; they count as the applicable meal. Do not include the cost of these meals as a field trip. If you are using actual for meals, then this can be included as a meal expense.

Education
Education is another fee with more to consider. Many states are now requiring early childhood education units or other related course work to be taken each year to maintain licensing. This is allowed as continuing education. Don’t forget to include textbooks (supplies) and to count this mileage as deductible.

Obtaining a degree or certificate does not preclude this from being an allowable business expense (26 CFR 1.162-5.) However, if the education is the minimal educational requirement to obtain a license, this is not a deduction. Also, do not double dip and claim an educational credit and the Schedule C deduction for the same expenses. You should determine which treatment is preferable for the tax circumstances of the taxpayer. Often, Schedule C will be a better option for the taxpayer, but your software will probably not be able to help you figure this out. This is also something that makes us “better than the box”!

Depreciation
You must use straight line for many assets since MACRS is not allowed for less than 50 percent business use (neither is §179). A typical allocation method is to use the time/space percentage to allocate between personal/business use of assets. This percentage is seldom 50 percent or greater, thus straight-line depreciation would be required. Because bonus depreciation is now 100 percent and allowed for used items acquired by the taxpayer, it may still be possible to take 100 percent of the business use in the year of acquisition.

Most day cares start using items already in the household as mixed-use items: kitchenware, appliances, furniture, electronics, etc. These can be depreciated from the first day of business as a used item valued at its current fair market value (FMV). The basis for these is not what was paid for them new, despite what your client may want to believe. How do you determine the values? Websites like Ebay, Craigslist, Goodwill, Salvation Army, and other sources that list values for used items may be a handy resource for the DCP to consult.

If the DCP can find receipts for the initial purchase, that is a great place to start. For example, is the refrigerator a year-old $2,800 model or a 10-year-old $500 model? The newer, more expensive model should receive a higher value than the old one. However, unless the older model was deducted for a business purpose, it still gets depreciation treatment. So do not overlook this deduction. Pictures and lists are very helpful for documentation come audit time.

Safe Harbor Election
Do educate your clients about the safe harbor elections. They need to make this before the start of each year, and they should do so in writing. Make sure they are using some sort of “system” for accounting as this election is meant to tie books to taxes. Frequently, DCPs will keep records through a child-care website, receipt software, bookkeeping software, spreadsheets, or a manual ledger. These are all methods of accounting the DCP can choose to use to classify purchases.

Making the choice to classify all items under §1 means they do not put those assets in their capital expenditures areas. Though $2,500 is allowed as the maximum, is that the amount your client should adopt? Though this may be easier for tracking some smaller items, it may not actually be in the best interest of the DCP to use the full amount. If this reduces the DCP’s income to the point other benefits are lost, perhaps making the election for a lower threshold will make more sense. This would move more assets onto the depreciation schedule, allowing for decisions to be made with regard to the best overall result for the taxpayer. Sometimes taking more deductions is not the best for the client.

Choices and Elections
A word of caution about depreciation: Do not overlook the power of using the timing of expenses to maximize the tax benefits to clients. If a DCP is already at a loss and has zero taxable income for the year when this loss is combined with other income, consider if making an election out of bonus depreciation or out of MACRS into straight line might be better for the client. This is one area where you can legally manipulate the taxpayer’s liability and/or credits.

Employee Benefits
Most DCPs are exempted from the requirements to provide medical coverage under the Affordable Care Act as they usually have fewer than 50 employees. Virtually all home-based child-care providers have fewer than 25 employees and might consider providing benefits under the SHOP (Small Business Health Options Program) exchange. Remember, the DCP may qualify for the small employer health-care credit

Sometimes taking more deductions is not the best for the client.
if she does this. In some areas, it can be a competitive advantage to offer medical benefits to attract competent assistants. Offering coverage to employees, especially if the bona fide employees are family members, may give the DCP better opportunities to maximize the medical deduction options.

Under the rules for self-employed medical, medical insurance premiums do not go on Schedule C; they are an adjustment to income to the extent of profit. The remainder flows to Schedule A. If the bona fide employee is the spouse of the DCP, the premiums of a policy for the employee spouse, even if the benefit extends to the DCP and her children and the same benefit is offered to all qualified employees, then the premiums are deductible on Schedule C. In addition, setting up a qualified §105 plan may further maximize the allowance of medical expenses as a deductible item.

Rarely do DCPs invest in employee retirement plans. The few taxpayers who do so usually do this so that they can take a personal deduction greater than the IRA allowances. Another situation is offering great retirement benefits to all employees and all employees happen to be family members.

Insurance
Day-care insurance (DCI) is a common expense for day cares. Though the acronym is straightforward, many will use this acronym exclusively. This is because many DCPs buy from DCI Insurance Services. This is a liability insurance policy that covers the provider for negligent supervision, child-abuse defense, food preparation, residents of the household and the employees, field trips, personal injury, infants, auto transportation of enrolled children, nonowned auto liability, and related matters. This is generally much more coverage than the typical homeowner’s and/or auto policy, and it is relatively inexpensive. Having this kind of a policy can also help establish this is a business—not a hobby—should a hobby loss question arise in an audit.

Homeowner’s insurance is part of Form 8829. An umbrella policy would also be mixed use and should be allocated business vs. personal. Prepaid legal services, home warranties, and appliance warranties are examples of other types of insurance the taxpayer may have that are also mixed use and should be allocated accordingly.

Workman’s compensation is required in most states for most employees. Often, the providers use “pay-as-you-go” services through a payroll service and do not have this number readily available. Be sure to help them catch this important deduction. Some do not have to have a separate workman’s compensation policy as they have riders in their homeowner’s policy to provide this coverage or are exempt from providing coverage. If the rider is separately stated, this would be 100 percent deductible and not part of the home-office calculation. Check the local laws and the insurance policies with your clients to make sure they are compliant in this area. The penalties for not being in compliance can be substantial.

If the benefits for owner disability or life insurance are excludable from income under §104, do not deduct these as business expenses. This is almost always the case, even if such policies are required under the provisions of a loan.

Because of the information child-care providers must provide clients in order for them to claim a credit for child care, there is an argument that identity theft insurance might be substantially business related. Consider the facts and circumstances before claiming 100 percent of this expense as business.

Interest
Section 163 describes the various instances when interest is deductible. Child-care providers often overlook this deduction. Common cases of deductible interest for day cares include the following:

- Business portion of credit cards. Remember, principal paid on credit cards applies first to personal, then to business. Ideally, the taxpayer will have credit card(s) used exclusively for business. See Publication 535, Business Expenses for more specifics on the allocation ordering.
- Mortgage interest. This belongs on Form 8829, not on Schedule C, unless the loan is specifically identified as a business loan, and the taxpayer has
elected out of mortgage treatment. Under the Tax Cut and Jobs Act of 2017 (TCJA), substantial changes to mortgage interest deductions have occurred. Though discussion of these changes and the rules of mortgage interest are beyond the scope of this article, understanding this topic may prove quite useful in allocating certain mortgage interest on Schedule C.

- Loans. If loans are from friends or family, make sure they are true loans and that interest is paid and properly reported on a 1099-INT. Loans made to oneself or from spouses are not loans and are simply owner capital contributions.
- The business portion of the business vehicle interest is deductible, even if the taxpayer uses the standard mileage rate method of deduction.

Legal/Professional Fees
Many kinds of fees fall under legal/professional fees. Common day-care expenses in this category include:
- Tax prep. Resist the temptation to put all your fees here, and do verify what the client has included here, as she will often include the whole amount in a lump sum.
- Bookkeeping. These fees are 100 percent deductible in most cases.
- Payroll services. Many payroll services do not make it clear how much they charge each year for their services. Clients frequently will tell me it is only $30/month, but when we add up all the fees and charges, we find they are spending well over $2,000/year. Help them to capture all of this deduction.
- Lawyers. To the extent they are used for the production or protection of taxable income related to the business, this is a deduction. Carefully watch for divorce, child support, and other personal items thrown into this category.
- IT professionals. As the world becomes more technology oriented, DCPs are adding technology to their businesses, and the costs of professional services to install, set up, manage, and otherwise assist with technology are deductible. For mixed-use items, such as a home entertainment system, this expense should be allocated between personal and business use.

Office Expenses
Office expenses include any expenses generally related to the administrative function of a business. This is an area in which preparers will often list small expenses and then list many other office expenses under “other” on line 27 of Schedule C. It is preferable to include expenses in the category to which they relate in order to keep the figure in the other category as small as possible. Why? The other figure is a catch-all category that is often selected as an item to audit. Use subschedules for categories on Schedule C to include expenses that will reduce the size of the other category, thus making it less likely to trigger an audit ... in theory.

Office supplies are obvious and include such items as paper, pencils, staplers, etc., used for the business portion of the day care, which is different than the supplies used for curriculum or arts/crafts. Though there is nothing wrong with reporting supplies in this category, it can make the figure appear higher than comparable businesses and create a question for audit.

Postage is one of the areas that might be mixed use if the DCP is counting the postage for mailing household bills. With the popularity of online bill pay, this is becoming less of an expense. More often than not, the return-shipping costs of items ordered online fall into this category.

Other office expenses may include web-based services, software, costs for check printing, and any other administrative business expense.

Communication
Land lines create a challenge for day cares. If 100 percent of the land line is for business, and a second land line is also at the home, then the land line is 100 percent deductible. If it is the only land line in the home, even if it is used 100 percent for business, it is not deductible at all (§262(b)) even if local law requires the business to have a land line. Costs of extra services, such as long distance, call waiting, caller ID, etc., may be allocated based on business use. If claiming 100 percent of these extra services, be sure you can support why these are not personal in any way.

Since 2010, cell phones are no longer listed property under §274. So the logs for substantiation are no longer required. However, this does not mean they are 100 percent deductible. Check with the taxpayer as she will often try to include the whole bill, including costs for other family members. Help her identify what is the proper amount to deduct. Suggest she answer the phone in the name of the business and reference...
repairs will go on Form 8829. If the expense is 100 percent related to the expense is 100 percent business use if there is proof it is 100 percent business use if there is no allocation of the cost. If the repair is related to mixed-use items, such as appliances, the expense needs to be allocated between personal and business. Applying the applicable time/space percentage from the 8829 would be the most logical and easily substantiated allocation method.

Supplies
This is usually a big category for day cares. Breaking this into several subcategories can help keep the DCP organized in determining mixed use and having supporting documentation for an audit. Common subcategories include anything that is consumed or used in the business for the purpose of carrying out the activity of the day care that is not included in another category.

Baby supplies include diapers, gloves, powders, car seats, cribs, and any other supplies unique to the care of an infant/baby. Before taking the deduction, make sure the taxpayer is not charging parents for these items (if so, include the income). If the client also has a baby, be sure you can support the separation of business versus personal, or take a percentage. Often these supplies are purchased at the grocery store or warehouse store. Be sure the taxpayer is pulling the personal-use amounts out of the grocery receipt. When DCPs take the standard rates for meals, discussed later, it is not uncommon for the entire receipt to be ignored.

Safety/first-aid supplies include items such as bandages, fire extinguishers, gates, plug covers, latches and locks, and other similar items. Virtually all DCPs will have these kinds of expenses, though many do not take this into consideration.

Cleaning supplies are usually mixed use, and the costs should be allocated. Some DCPs keep specific supplies for the day care. An example is disinfectant wipes purchased for toys and other items the kids use. If this type of supply is solely used in the day care, advise the client to develop some manner to support 100 percent use. Photographs are great documentation, particularly if they show items with labels indicating day-care use with similar items not labeled in this manner. Writing the label directly on the item with a Sharpie or similar instrument is cheap and fast.

Party supplies are common with DCPs. Children like special occasions, and some providers will host holiday, birthday, summer, and graduation parties, etc., for the children. Make sure this is not disguised as a personal event or an event that needs to be allocated.

Decorations are another kind of supply. This may include such things as learning décor (alphabet posters) as well as day-care-specific décor items, which are 100 percent allowable. Household décor in mixed-use areas would be allocated between business and personal.

Storage supplies often amount to a relatively high expense for some DCPs, particularly in the early years of operation. Examples of deductible items include cubbies, tubs, containers, etc., for housing day-care items when not in use, and they are 100 percent allowable. Otherwise, allocate if mixed use.

Laundry supplies are likely allocated between business and personal, unless products are specific to just the day care such as sensitive-skin laundry soap used only for day-care blankets, pillows, towels, etc. If the day care does not provide any linens of this nature, and instead requires the parents to provide these things, then business laundering will be incidental and related expenses should not be reported, nor should the laundry space be included in the time/space percentage.

Clothes are sometimes stockpiled by providers. The provider may have a few outfits in inventory for the occasional accident for which the parents did not provide adequate replacement clothing. Be able to support these are hand-me-downs (which are...
The Ins and Outs of
Day-Care Provider Taxes Part II

Penalties related to any payment to any government entity are never deductible.

Educational Curriculum
These materials are a big expense for many providers. DCPs will order workbooks and other materials for specific educational goals/programs. It might be a good idea to obtain copies of this curriculum as samples in the event the return is selected for audit.

Books
Books may be a subcategory separate from educational curriculum. These can be both for the children and for the provider’s education/reference as business expenses. You might include textbooks as needed for the coursework of the provider. Again, if the books are used for both day-care clients and the DCP’s children, the expense needs to be allocated.

Gifts
DCPs often celebrate holidays, birthdays, and other milestones as part of their day-care activity. Section 274(b)(1) limits the deductible value of gifts to no more than $25/person/year. What is a gift? Per $274(b)(1):

- The term “gift” means any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter.

- Per the ATG for CC, the following is added: Examiners should not confuse expenses related to activities done with the children with gifts.

Using the two preceding citations, it is important to educate the provider regarding the limitations and substantiation, as well as being able to determine if a celebratory activity that includes children opening packages should be reported as a gift or as an activity/event/party supply.

For employee gifts, the $25 limit is pretty strict. Any items otherwise given to an employee, whether cash or items, should be added to compensation and taxed as wages.

Taxes and Licenses
Certain permits, such as alarm permits, must be allocated as mixed-use expenses. Other permits, such as a city inspection permit, would be 100 percent for business.

If a day-care license is required, the DCP should pay a fee for it. This is where you can determine if the taxpayer is entitled to the day-care treatment for expenses, such as the special business-use-of-home expenses: no license, no special treatment unless specifically exempt. An auditor will most certainly request a copy of the license for the year(s) in question.

The employer portion of payroll taxes paid for both federal and state are deductible provided they are actually paid under the cash method of accounting, which applies to most day cares. Many small employers get behind on payroll taxes, and, if they are not current, they cannot deduct the employer portion as taxes nor can they deduct the employee portion as wages.

Many local governments require business owners to file a personal property tax return and pay taxes. Some jurisdictions exempt home-based businesses from this tax. If it is paid, it is a business expense.
Many local governments will require a business license in addition to a day-care license. Again, if it applies, this is deductible.

Penalties related to any payment to any government entity are never deductible. This includes payroll tax penalties, parking tickets, fines for license violations, etc. Taxpayers will usually record the penalty with the payment and think the entire amount is deductible.

Travel
This is also mentioned in the $274 extra documentation categories. Be sure the DCP has documented the how, what, where, when, and why of expenses for transportation, lodging, and local incidental expenses that she paid for travel to industry conferences, classes, seminars, conventions, etc. Travel for the provider and/or any bona fide employees is deductible. Family members not on payroll and issued a W-2 are not bona fide employees, even if they spend substantial time working for or in the day care.

Meals and Entertainment
This is another $274 extra documentation category. There are several types of meals provided by DCPs.

Employee meals provided for the convenience of the employer on the employer’s premises are deductible at 50 percent of the cost. This used to be 100 percent, however, the TCJA has halved it. Currently, after 2025, there is no deduction allowed for meals to employees for this purpose.

Other meals, such as those with vendors, parents, prospective parents, etc., may be considered entertainment. There is some controversy regarding this matter as the TCJA eliminated all entertainment expenses. If these expenses are still deductible, documentation per §274 is still required, and the DCP can claim only 50 percent as a deduction. The most conservative interpretation of the TCJA says these meals are entertainment and will therefore not be allowed as a deduction.

Travel meals—meals in conjunction with overnight travel away from home—are deductible at 50 percent.

Children’s meals are 100 percent deductible under §274(n). However, no meals for the provider, his or her own family, including children in care, are deductible under §262. There are two methods possible for deducting meals for children. Only one method may be used for an entire year, but it is a year-to-year choice on which method is used.

The U.S. Department of Agriculture Food and Nutrition Service administers the Child and Adult Care Food Program (CACFP) known in day-care circles simply as “the food program.” The food program provides reimbursement for meals and snacks served to small groups of children receiving day care in private homes that are licensed, registered, or approved to provide child care.

The program provides meal standards and guidelines on what foods can/cannot be served. Menus have to be submitted and reviewed. It is not a simple “chart the meals and get money” type of program.

Reimbursement rates are revised each July, and they are reimbursed as either tier 1 (full rate) or tier 2 (reduced reimbursement). Tier 1 applies to lower-income situations and is the amount eligible to be deducted as an expense, per the IRS standard meal-allowance deduction. Rates are higher for Alaska and Hawaii than the contiguous states. See the table below.

Reimbursements are limited to no more than two meals and one snack per child per day or one meal and two snacks.

A nonprofit “sponsoring” organization administers the local food programs. Many organizations require the use of KidKare (formerly called Minute Menu) as the method for reporting and recording the required menu information and meal counts. Encourage providers to enter in all meals served—whether or not they can be reimbursed for them—as this provides a resource for supporting the total allowable deductions. More on the deductions are explained later.

CACFP reports are simple and easy to follow. These reports will show the amount of pay the DCP received. The next line will show the amount paid for the DCP’s own children. This is not income and should not be included as such if the DCP qualifies under the poverty rules. However, the meals for the DCP’s children are never deductible as this is a personal expense.

The middle section of the report will show the total meals logged through the program broken out by reimbursable and unreimbursable for each type of meal. The total meal counts and costs will include both types of children.

Finally, the third section of the report is broken out by month. This will include months from the prior year as well as some months in the current tax year. The deduction is based on the current calendar year. To be clear, the deduction is for the meal counts for each month of the calendar year.

Food program income is not taxable. However, food served to children is deductible.

RATES FOR JULY 1, 2018, TO JUNE 30, 2019

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</tbody>
</table>
Because IRS will assume a return with only a food deduction is claiming the full amount, including the reimbursed portion as an expense, it makes sense to report the food program income (excluding amounts for the provider’s own children) as “Other Income” (Schedule C, Part I, line 6) and then deduct the full amount (excluding any amounts for the provider’s own children) as 100 percent deductible meals and entertainment. (Some software will allow for this on Schedule C, Part II, Line 24b with entry for 100, 80 [U.S. Department of Transportation], or 50 percent data entry fields. If your software does not allow for this, consider taking this expense as a supply (Schedule C, Part II Line 22).

The standard meal rate is the easiest method to use. Using the rates discussed under the food program, DCPs can deduct meals for children based on the standard rates published by the CACFP. They should use the tier 1 rate under CACFP even if they are tier 2 or do not participate in the food program. Unlike the food program, which allows reimbursement for no more than two snacks and one meal or two meals and one snack, IRS allows deductions for up to one breakfast, one lunch, one dinner/supper, and up to three snacks per day.

Have the DCP document all meals, not just those for which a reimbursement is allowed.

Regardless of the method chosen, clients should review receipts for nongrocery items they may have purchased at the grocery store or wholesale store for items that can be deducted elsewhere. This can include cleaning, kitchen, and safety supplies; repair or maintenance items; and even some toys or other activity supplies.

Because this is still a meals expense, even though it is 100 percent allowed for business purposes, the taxpayer is still subject to §274, and substantiation for meals is required under §6001 and Regulation §1.6001-1(a). Substantiation records include the name of the child, dates and hours of attendance, and the type and quantity of meals served. KidKare is the standard tool most child-care providers use for this tracking, though any method of tracking, including spreadsheets, manual logs, calendars, etc., is acceptable.
Wages
If the payments are wages, a 1099 is not appropriate. There is widespread abuse in small businesses related to the misclassification of employees as independent contractors. Day cares are no exception to this. IRS and many states are hitting this hard as an audit item, especially if the wages claimed do not tie to the W-2.

Remind your client that 1099s are issued to businesses that hold themselves out to the public to provide the services being purchased and that anyone they “hire” as an assistant, no matter how little he or she is paid or how infrequently he or she is used, is more than likely an employee and not an independent contractor.

Employee wages are properly recorded on a W-2, and corresponding payroll reports are also filed, including Form 940 and either Forms 941 (quarterly federal employment tax reports) or 944 (annual federal employment payroll tax reports if the total liability is $2,500 or less per year.) Simply paying cash and choosing not to deduct the expense does not negate the payroll tax requirements nor does it remove the risk for penalty. It is fairly easy for an auditor to spot when cash payments are made, and regular cash withdrawals are seen.

Children/spouses can be employees of the DCP in many cases. Special rules apply to hiring family (See Publication 15, Circular E, Employer’s Tax Guide for more information). Children of the taxpayer under age 18 are exempt from Social Security tax, Medicare tax, federal unemployment tax (FUTA), and often the state equivalents. Children of the taxpayer under age 21 but over 18 and an employee–spouse are exempt from FUTA and often state equivalents.

In order to be a bona fide employee, which allows the deduction of wages and other business expenses, including related travel, cell phone usage, etc., family members must provide services to the business. The services must be time and age appropriate. Time cards, job descriptions, etc., will help substantiate this powerful deduction.

The compensation should also be reasonable. Is it reasonable to pay a five-year old $10,000 a year? The compensation needs to be paid, as well, and not just credited on paper or classifying expenses paid with the provider’s money as being the family member’s compensation.

Other Expenses
These are reported on Schedule C line 27. Avoid using this line whenever possible. Virtually all expenses can be classified elsewhere on the return. In talking with numerous auditors, it is apparent that any dollar figure of significance reported on this line is a call to be audited. This relates to the ambiguity of what is included as “other.” Start-up expenses will be “other” as there is no other place to put them.

Section 199A – Qualified Business Income Deduction
The TCJA brings with it many changes for tax returns. A full discussion on the $199A qualified business income deduction (QBID) is beyond the scope of this article. If the total income for the DCP’s tax return does not exceed the stated thresholds ($315,000 MFJ/$157,500 all others), the DCP will qualify for the QBID without having to consider W-2 wages or asset values, or whether the DCP business is a specified service, trade, or business.

The allowed deduction would be the lesser of 20 percent of the business income or 20 percent of the taxable income. For most DCPs, they will be able to claim some QBID. If the only income the DCP has is the profit from the business, then the amount will likely be reduced to 20 percent of the taxable income. If the DCP has other income, such as a spouse’s W-2, there may be a full 20 percent allowed for QBID.

For Your Review
1. What code section allows for ordinary and necessary business deductions?
   A. 160
   B. 161
   C. 162
   D. 163

2. Which of the following would result in a deductible expense for a DCP?
   A. The cost of meals at McDonald’s on a field trip if the DCP uses the standard meal rate for deductions
   B. The cost of gasoline for a field trip if the DCP uses the standard mileage rate for deductions
   C. The cost of paying a flat weekly allowance to the DCP’s children if the DCP’s children play with the day-care kids
   D. The cost of call waiting, caller ID, and long-distance phone calls on the landline, the only phone in the home used only for business

*See page 60 for the answers.

Conclusion
There are many issues with day-care providers that are unique to them. Hopefully, after reading the articles in this series you have a better understanding of the issues involved and are better equipped to serve your clients who operate a day care. EA

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