

Phyllis Rosales Tax Court Settlement Notes

Below are the settlement notes that I prepared for my meeting with IRS attorneys to settle this case before a Tax Court trial.

Health insurance deduction

Taxpayer position: \$1,480 Schedule C deduction

IRS position: \$0

Taxpayer claimed \$1,480 in health insurance premiums as business deductions on Schedule C as part of a medical reimbursement plan for her employee (Mr. Rosales).

The IRS took the position that the taxpayer could not deduct health insurance payments because she is eligible to participate in her husband's medical plan.

A recent Tax Court case directly addresses this issue (T.C. Summary Opinion 2006-25) where the court ruled that a family child care provider could deduct such expenses as part of a medical reimbursement plan for her employee husband.

The court said:

"Under section 162(l), a self-employed taxpayer may deduct the cost of medical insurance premiums under certain conditions. A self-employed taxpayer may not deduct the cost of medical insurance premiums, however, if the self-employed taxpayer is eligible to participate in a subsidized health plan of another employer of the taxpayer or of a spouse's employer. Sec. 162(l)(2)(B).

"Mrs. Speltz is self-employed. She deducted on the daycare Schedule C the cost of medical insurance premiums paid for Mr. Speltz under the daycare's accident and health plan for employees, and she was eligible to receive medical benefits through Mr. Speltz's subsidized health plan with Fastenal, his full-time employer.

"While section 162(l) applies to Mrs. Speltz because she is self-employed, section 162(l) does not apply to Mr. Speltz. See sec. 162(l)(1)(A), 401(c)(3). Because the premiums were paid for medical insurance for Mr. Speltz, the limits of section 162(l) and section

162(l)(2)(B) do not apply. Accordingly, petitioners are entitled to deduct their expenses for medical insurance premiums for Mr. Speltz."

In our case Mrs. Rosales hired her husband and her daughter and these wages (\$4,783) were allowed as a business expense by the IRS examiner. The tax examiner has admitted that there was a bona fide employer/employee relationship. Mrs. Rosales hired A&T Inc. to establish her medical reimbursement plan (see enclosed document). Mrs. Rosales followed the terms of her plan and the premiums paid by Mrs. Rosales were for the benefit of her employees. Therefore she should be allowed to claim this deduction on her Schedule C.

It appears that Mrs. Roseles' tax preparer mistakenly put the \$1,480 in reimbursed health insurance expenses on Form 1040 (subject to the 60% limitation) rather than on Schedule C as her business expense.

Because taxpayer established a medical reimbursement plan she is also entitled to deduct other employee medical benefits (\$2,455 for 2001 and \$2,970 for 2002). The auditor documented receiving receipts for these amounts. The auditor notes that in 2002 Mr. Rosales did not spend about \$800 of the money set aside for medical expenses in his cafeteria plan. This is still deductible to Mrs. Rosales because it was for the purchase of medical insurance (house insurance is still deductible even if no claim is made during the year). Even though all of the money set aside was not spent, the balance was returned to the company and not received by the Rosales family. So, this represents a medical expense to Mr. Rosales that was reimbursed by Mrs. Rosales.

To deduct medical expenses under a medical reimbursement plan it is not necessary for the employer to pay a salary (see the Speltz case where the provider paid no wages to her employee husband). In our case, in 2001 the provider paid her husband \$576 in salary and her daughter \$4,207, for a total of \$4,783. Her husband worked approximately hours during the year and her daughter worked approximately hours (see attachment). When the amount of health insurance expenses and other employee benefits are added to their salary, they are still earning a reasonable wage for their work, or about \$10 per hour.

Car/Truck Expenses

Taxpayer accepts the IRS position regarding the car/truck expenses for the years at issue.

Depreciation

The taxpayer claimed a home office business percentage of 42% and the IRS examiner allowed 22%. We are challenging this reduction (see discussion below). This percentage difference affects the depreciation for the house, roof, and dishwasher.

	<i>IRS Position</i>	<i>Taxpayer Position</i>
Property	Home	Home
Cost Basis	\$80,000	\$80,000
Business %	22%	46%
Business Basis	\$17,600	\$36,800
Method	39yr SL	39yr SL
Deduction	\$464 (2001) \$451 (2002)	check tables

Property	Roof	Roof
Cost Basis	\$7,234	\$7,234
Business %	22%	46%
Business Basis	\$1,592	\$3,328
Method	39yr SL	39yr SL
Deduction	\$2	\$85

Note: Examiner's math was incorrect. The correct deduction using a 22% business use would be \$41, not \$2.

Property	Dishwasher	Dishwasher
Cost Basis	\$555	\$555
Business %	22%	46%
Business Basis	\$122	\$255
Method	7yr HY	7yr HY
Deduction	\$17	check tables

Taxpayer cannot find her records of the equipment purchased in July 1998 and October 2000 so we are not challenging the denial of the deduction for these items.

Taxpayer purchased two rocker/recliners in a two-for-one sale (cost?). She used one of

the rocker/recliners exclusively for her business by rocking the children to sleep. It was also used by the parents of the children when were in her home. The second rocker/recliner was used by both her business (used by the day care parents and by the day care children) and her own family. Originally the taxpayer claimed 100% of the cost of both rocker/recliners. Upon review we are requesting a deduction of 100% of the cost of the first rocker/recliner and the Time-Space percentage cost of the second rocker/recliner.

The Bose radio was a combination radio, DVD and CD player (cost?). The taxpayer used this equipment in her business when she played music CDs for the children. She also had her record player connected to the Bose speakers when she played records for the children. The Bose system was used several times each week. This use is clearly ordinary and necessary. Taxpayer originally claimed 100% of the cost of this item and upon review we are requesting to deduct the Time-Space percentage of this cost.

Van - The IRS disallowed the cost of the finance charges for the van and for the service contract. These items should have been allowed as a proper van expense. It is not clear from the record whether the business portion of these expenses were allowed on Schedule C.

Computer, playhouse, camera - TS% or 100%?

Legal and Professional Services

Taxpayer position: \$300

IRS position: \$390

The IRS examiner allowed taxpayer to deduct \$90 paid to the A&T Inc. and Business Tax Service for preparing payroll taxes. We accept this position.

Repairs and Maintenance

Taxpayer position: \$1,108 Schedule C deduction

IRS position: \$13

The IRS allowed the expenses for exterminating, duct cleaning, and carpet cleaning on Form 8829 where it was deducted using the Time-Space percentage. We accept this position for the extermination, and carpet cleaning cost. We believe we are entitled to

deduct 100% of the cost of the duct cleaning (how much?). In 2002 the taxpayer cared for a child with asthma. Taxpayer is required to comply with the rules of the Americans with Disabilities Act to accommodate children with disabilities. She had her house ducts cleaned to improve the air quality of her home and make it easier for this child to remain in her program. She had never before had her ducts cleaned and she has not had them cleaned again since.

It appears that the IRS hearing officer also disallowed the cost of cleaning the furnace, dryer repair, lawn mower repair, garage door repair, and Roto Rooter. It is not clear if these items do appear on Form 8829. All of these expenses are clearly ordinary and necessary for the maintenance of her home business. She must have her furnace, dryer and lawn mower in good repair to run her business. She must have her house plumbing system in good repair as well. Although the taxpayer originally claimed these items as 100% business, upon review we believe these should be deducted on Form 8829 and apply the Time-Space percentage.

Travel Expense

2001

Taxpayer position: \$857

IRS position: \$802

2002

Taxpayer position: \$2,531

IRS position: \$78

In 2001 taxpayer traveled three and a half hours each way to Springfield, MO to purchase leather craft supplies at a leather goods store. She spent approximately three to four hours in the store getting instruction on how to use the leather materials in various craft projects with her children. There was no similar store in her hometown where she could purchase these materials. Taxpayer does not remember if she bought other personal items in Springfield on this trip, but it is likely that she did. Taxpayer is allowed to deduct miles for trips if the primary purpose of the trip is business related. In this case, the primary purpose was to buy leather craft supplies. The trip to Springfield was primarily for business purposes and therefore the cost of the hotel (\$54) in Springfield is an ordinary and necessary business expense.

Hawaii conference

Taxpayer attended a week-long business conference in Hawaii and deducted the cost of this trip, along with the cost of the trip for her daughter who was her employee.

IRS Code Section 162 allows travel expenses while away from home in the pursuit of a trade or business as long as the "primary" purpose of the trip was business.

The IRS MSSP Child Care Audit Guide states: "Travel away from home overnight may consist of attending seminars."

The taxpayer tried to book a flight for the business conference immediately before the conference began (December 1st) but could not get a flight that left any later than November 24th. She spent November 24th as a travel day. She then spent 6 days in Hawaii before the conference began. The conference lasted 6 days and then she spent another travel day getting home. She was away from her home a total of 14 days. Two of these days were travel days. According to IRS Publication 463 Travel (look up) taxpayers are allowed to count their travel days as business days in determining the primary purpose of a trip.

During the 6 days attending the business conference, she spent 21.5 hours in workshops, plus an additional 6 hours walking to and from her hotel to the conference site (1/2 hour each way). She also spent an additional 5.5 hours during the 6 day conference visiting a local family child care home where she talked to a provider who used the Montessori philosophy with her children. The conference organizer gave her a Hawaiian Culture Sticker for these 5.5 hours. Taxpayer submitted records of her attendance at the conference workshops and the extra hours on this Sticker. This makes a total of 27 hours of business activities during these 6 days.

During the 6 days the taxpayer spent in Hawaii before the conference began she also spent time on a variety of activities that she used to enhance her child care business once she returned home. She took many photos of a Buddhist Temple (to teach children about other religions), lighthouses and other landmarks, Botanical Gardens (she brought back plant starts to try and grow a tropical garden for the children in her home), dolphins (to show children unusual animals), pineapple plantation (she bought a book to help teach children how to grow pineapples - she still has a pineapple plant growing in her home),

and Christmas parade (to show children how the holiday is celebrated differently in Hawaii). In addition, taxpayer spent 2 and a half hours visiting the Hickam Air Force Base Child Care Family Services office where went to learn about the different licensing requirements and other qualifications providers had in Hawaii (ask her about this).

The six days spent at the conference were primarily for business purposes because she spent more than half of the time each day on business activities. If we add the two travel days as business days, the total is eight business days. During the other six days in Hawaii the provider spent a number of hours on activities that she used in her business upon her return. This is not a case of a provider taking a vacation and conducting a few hours of business activities in an attempt to deduct the entire travel costs. The primary purpose of the trip to Hawaii was to attend the business conference and therefore the cost of the travel should be deductible.

Taxpayer deducted the hotel expenses for the 6 days she was attending the business conference (\$693). The IRS denied this deduction. Clearly, this deduction is valid regardless of whether or not the travel expense is allowed.

In the first draft of the IRS examiner's report she did allow the taxpayer to deduct her trip to this conference.

Daughter's trip to Hawaii

Taxpayer's daughter has been her employee since 1999. She worked an average of 60 hours a month or a total of 720 hours a year. She was paid \$4,300 in 1999, \$4,300 in 2000, \$4,300 in 2001, and \$60 in 2002. The reason she worked fewer hours in 2002 was because she was away from home for several months and started another full time job. Her pay was approximately \$6 an hour, so this conference an additional reward for all the work she had done for me in previous years. In 2002 her plans were to continue to work for my business in later years and she retained her state-approved status as a substitute. The daughter also attended workshops at the conference (see attached certificate). The knowledge she gained from attending the Hawaii conference would be put to use in her work as a substitute after her return home.

Meals and Entertainment

2001

Taxpayer position: \$150

IRS position: \$101

2002

Taxpayer position: \$413

IRS position: \$81

The meals in 2001 were for her trip to Springfield.

The meals in 2002 were for the Hawaii business conference. Since the 6 day conference was clearly business, the meals eaten during these 6 days should be allowed ($\$406 \times 50\% = \203).

check into 2002 deduction

Schedule C Other Expenses

<i>2001</i>	<i>Taxpayer position</i>	<i>IRS position</i>
Dues and cable	\$540	\$133
Telephone	\$785	\$272
Seminars	\$155	\$125
Exterminator	\$415	\$0
<i>2002</i>	<i>Taxpayer position</i>	<i>IRS position</i>
Telephone	\$466	\$248
Exterminator	\$280	\$0
Cable TV	\$438	\$0
Cell phone	\$395	\$0
Dues	\$188	\$120
Seminar	\$639	\$530
Internet	\$287	\$0

Note: IRS allowed the Exterminator expense on Form 8829 and we accept this position.

Cable Television

The IRS examiner's report states that cable television is strictly a personal expense and can never be deducted as a business expense. However, in the *Simpson v. Commissioner* Tax Court case (Tax Court Memorandum 1997-223, May 12, 1997) the court allowed the deduction of cable television as a business deduction on Form 8829 as a household utility. The court said, "Petitioners also deducted expenses relating to cable television, gas, electricity, telephone service, garbage removal, and water. The deduction for telephone service is expressly prohibited by section 262(b). The remaining utility expenses are deductible, subject to the limitations of section 280A(c)(4)." In the *Simpson* case the petitioners failed to provide sufficient evidence that they used the cable television in their business, but the court's ruling clearly states that cable television should be treated in the same manner as other household utilities. Therefore, we should be entitled to claim cable television on Form 8829.

Telephone

The disallowed phone expense was for a "works package" offered by the phone company. This extra service is on the first phone line in the home. This phone line is the advertised number used in the taxpayer's business. The "works package" allows the taxpayer to pick up an incoming call when the phone is in use and allows her to see if a parent or some other business-related call is coming in. The package also allows the taxpayer to use caller ID and to record phone numbers as a part of her business. IRC section 262(b) refers to the disallowance of "basis local telephone," not an extra feature such as a "works package." This extra business feature was not part of the basic phone service on the first telephone line. On her original tax return the taxpayer claimed 100% of this expense. Upon review we are willing to accept the Time-Space percentage of these expenses. Note: The Appeals Officer did allow \$247 for the "works" package.

Seminars

The IRS examiner disallowed a \$30 deduction for the cost of a frame for the taxpayer's diploma that she received for her Early Childhood degree. The taxpayer did not try to claim the cost of the college classes as a business expense. She framed this diploma and posted it on a wall in her entryway so her business parents could see her accomplishment. This is a marketing expense that helps the taxpayer to promote her business. Communicating this degree to parents strengthens her credentials. If the taxpayer had obtained a nursing degree before she began doing child care and framed her nursing

degree to show her day care parents what credentials she had, this would also be considered an ordinary and necessary expense for her business.

Cell phone

Taxpayer used a cell phone for her business in the following ways: she carried it with her in the back yard for emergencies and so parents could reach her quickly. She took the phone on field trips with the children for the same reason. Because the taxpayer was caring for eight or more children at one time, it would not be convenient for her to rush to another room to answer the phone and leave the children behind. A cell phone is an efficient way to communicate with parents, and keep children safe, and therefore is ordinary and necessary. Originally, the taxpayer claimed 100% of this cost. Upon review, we are willing to accept the Time-Space Percentage of this cost as a business deduction.

Internet

Taxpayer used the Internet for her business in the following ways: she did research for her child development classes, she emailed day care parents and received emails from these parents, she visited the website of the National Association for Family Child Care to get information and news about the field, she visited the website of the Redleaf National Institute where she read their monthly newsletter. The use of the internet in a business is common and is clearly an ordinary and necessary business expense. This expense should be claimed on Form 8829 as a utility and apply the Time-Space percentage.

Business Use of the Home

Family child care providers are allowed to claim expenses associated with their home under IRC section 280(A). The calculation for this deduction is based on a formula of space and time.

Space

Taxpayer's home is divided into the following areas:

First floor

220 square feet - room used exclusively for business - accepted by IRS

1,005 square feet of areas used regularly for business - accepted by IRS (classroom, living room, dining room, bathroom, kitchen, one bedroom)

221 square feet - taxpayer's main bedroom and bathroom - not agreed by IRS to be regularly used for the business

108 square feet - taxpayer's daughter's bedroom - not agreed by IRS to be regularly used for the business

Total: 1,554 square feet

Basement

1,554 square feet - The IRS hearing officer allows taxpayer to claim half of the square feet of the basement as regular use for business

Garage

483 square feet - not allowed by the IRS to be considered as part of the square feet of the home

Total square feet: 3,591

Basement

Taxpayer contends that this room is regularly used in her business based on the following facts: The basement is one open room. Taxpayer uses the basement for business activities on a daily basis. She does the laundry for day care children, gets cleaning supplies, removes food from the freezer and food off the pantry shelves. She replenishes art materials, rotates books and toys. All of these activities are directly related to her business. Taxpayer had to install a water sprinkler in her basement as a licensing requirement by the state fire marshal. Her day care children are required by the state to go into the basement every other month to practice a tornado drill.

The basement contains the following items that were used on a regular basis for her

business.

Some of these items are used exclusively for her business and some of them are used by both her family and her business:

Washer/dryer
Work bench
Baby walker
Baby sit and spin
Parachute
Children's books
Shelving and dressers with arts and craft materials
Teacher resource library and notebooks
School posters
Felt theme kits
Stuffed animals
Case of paper
Baskets/trays
Cleaning supplies
Toilet paper
Yearly tax boxes
Freezer
Games
2 strollers
4 tubs of dress up clothes
Theme boxes
Cabinet with extra school supplies
Science equipment
Dolls
Children's golf clubs
Case of cutting strips
Paper table cloths
Food pantry
Christmas decorations
Furnace
Children's store

2 play pens
Hot water heater
Baby swing
2 racks of children's VHS movies
Month curriculum boxes
2 children's rocking chairs
3 filing cabinets with school papers
Math equipment
Soccer nets/balls
Tubs of assorted toys
Paper towels
Children's Christmas and birthday gifts
Photos of the basement are enclosed.

The issue of whether or not a basement is regularly used in the family child care business was addressed in the Uphus and Walker cases (TC Memo 1994-71). First, it is not necessary for children to be playing in an area for that area to be considered regularly used by the business. In both cases Minnesota state child care licensing laws prohibited the provider from bringing children into the basement areas. The court said, "The fact that the children were generally not allowed in the areas is not dispositive of the issue. The issue is whether the area in question is regularly used in the operation of the taxpayer's day-care business, not whether or not the children are present in that area."

In both the Uphus and Walker cases the providers used their basement areas for storage of day care items and they were in and out of the basement retrieving and returning these items. The court also noted that Mrs. Uphus used a freezer in her basement for day care food and both Mrs. Uphus and Mrs. Walker had a laundry room in their basement that they used on a regular basis in their business. Based on the significant use of the basement by Mrs. Rosales and comparing her use of her basement with the use by family child care providers Uphus and Walker it is clear that Mrs. Rosales does meet the standard of using her basement on a regular basis for her business.

Garage

Taxpayer contends that this room is regularly used in her business based on the following facts: Contrary to the IRS examiner's report, the garage has electrical outlets, overhead

lighting, and has vents for heating and air conditioning. It is attached to the home and is used as an emergency exit in her business. Taxpayer did not store her car in the garage because there is no room for it. Taxpayer uses the garage at least three times a day, some days more. She would bring out the children's cots (14) and bedding and then return them each day after the afternoon nap. She would also enter the garage once a day to throw out trash from the business. Many times she had to put out diapers more than once a day.

Items stored in the garage included:

Covered trash cans

Kid size rakes

Tool box

Mower wagon

Yard tools

Kid size snow shovels

Riding lawn mower

Safety fencing

Shovels

Push mower

Push broom

Extension cords

Sleds

Bagger/Mulcher

Buckets

Yard leaf bags

Planting table with tools, pots, and dirt

14 children's cots

Shelving with auto items

10 car seats

Ironing board/irons

Laminator

Rubbermaid container on wheels with outdoor toys

Bench seat from 15 passenger van (to accommodate a child's wheel chair)

Shelving with paper cutter, Head Start Portfolios, baby monitor, Johnny jumper, calendar, bulletin board items, electronic toys, extra parts for toys, chalk, coloring books, items left by children no longer in attendance

Wooden cubbies
Children's bags of bedding
Ice melt
2 paint easels
2 bikes/helmets
Musical instruments
Tumble mat
Wet/dry vacuum
Newspapers
Hamster bedding
Cereal boxes
High chairs
Paint paper
Art work drying rack

IRS Publication 587: Business Use of Your Home states, "The term home includes a house, apartment, condominium, mobile home, or boat. It also includes structures on the property, such as an unattached garage, studio, barn, or greenhouse." Therefore, the garage should be considered as part of the total square of the home for purposes of calculating the home office deduction.

The IRS examiner argued that the garage should not be counted as part of the home because counting it would not increase the home expenses because it was not heated or air conditioned. In fact, the garage is heated and has air conditioning, as well as electrical outlets. In addition, the garage does increase home expenses. The garage was part of the purchase price of the home and is included in the depreciation deduction of the home. Its value is also included in the property tax calculation and the home insurance calculation.

The issue of whether or not a garage is regularly used in the family child care business was addressed in the Uphus and Walker cases (TC Memo 1994-71). In the Uphus case the provider was allowed to count her detached garage as regular use. In the Walker case the court ruled against the provider. Here is how the court distinguished these cases:

"The garage was used by Mrs. Uphus to park her car and store both day-care and personal items. Mr. Uphus' car was always parked on the street. The garage contained the majority of the outside day-care play items: i.e., scooter bikes, sandbox toys, wagons, a movable cardboard basketball hoop, a slide, etc. The garage was also used to store lawn chairs,

lawn-care materials, tools, a snowblower, bicycles, and miscellaneous other items that were stored in the rafters.

"During an average day, Mrs. Uphus and the older children were constantly entering the garage to retrieve and return the outdoor play items; the young children were not allowed to enter the garage unsupervised. A few times a month, when Mrs. Uphus took the day-care children on field trips, i.e., to the library, zoo, and grocery store, the garage was used to access her car. During the winter, the Uphuses used the snowblower to clear their home entrance for the day-care children, and in the summer and spring, the Uphuses used the lawn-care materials to maintain the yard. Often, Mrs. Uphus used the tools in the garage to fix the bikes or other play items.

"The Walker garage was rarely used in the day-care business. The children were prohibited from playing in the garage. The Walker garage generally contained Mrs. Walker's car and miscellaneous personal items of the Walkers. Mr. Walker's car was parked on the street. On occasion, one of the day-care children would leave a bicycle in the garage during the day. A few times a week, Mrs. Walker used the garage to access her car when she took the children on field trips, usually to the library, park, or zoo. Four days a week, the day-care children used the garage to access Mrs. Walker's car because she took the day-care children with her when she drove her child to preschool."

When we compare the facts of our case with the facts of these cases we can clearly see that Mrs. Rosales' use of her garage is close to the Uphus case and thus she is entitled to count the square feet of the garage as regular use in her business.

Taxpayer's main bedroom and bathroom

Taxpayer contends that this room is regularly used in her business based on the following facts: State licensing rules requires her to have an answering machine that is located in this room. Taxpayer checked for messages several times a day. She stored two marionette puppets under the bed and an oversized puppet on the headboard. These items were taken out of this room and used with the children once a week and then returned to the room. She used a vanity desk and chair in this room to do record keeping on a regular basis (at least once a week). She stores two file boxes that contain current children's files as well necessary paperwork (including business receipts) for her business. At least once each month she conducted specific paperwork in this room for the Food Program and Head Start in which she participated. She used this room as a sick room for children where they

would be kept until the parent arrived to pick up the child. This occurred approximately four times a year. The room contained a sewing machine and sewing materials that the taxpayer used every few months for craft projects for her business. The bedroom's bathroom contained first aid items, a scale and thermometer that were all used in the business. This bathroom was used by the day care children at least once a day. The only way to enter the bathroom is through the bedroom.

Daughter's bedroom

Taxpayer contends that this room is regularly used in her business based on the following facts: Taxpayer was in this room several times a day. This room was used for storage of two children's folding tables that were used approximately once a month for parent/child functions and when table space was needed outside of the regular classroom. The room also contains a three-foot shelf in the closet where the taxpayer stored art supplies, construction paper, beads, cutting magazines and a paper shredder. Taxpayer also entered the room on a daily basis to get a dust buster that was plugged into the wall of this room and was used by the children to clean up.

Discussion of Regular Use of Bedrooms

IRS Revenue Ruling 92-3 grew out of an audit of a Minnesota family child care provider. The ruling says, "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."

In the Uphus and Walker cases the court distinguished between a room that is used on a regular basis and one that is used only occasionally for business purposes: "we have found that the regular basis test is met where the taxpayer is able to establish that the business use is continuous, ongoing, or recurring." The court cited the Frankel case (82

T.C. 318, 325 (1984)) in which an editor was allowed to count an office as regular use when he had on average one business phone conversation per night.

In our case both bedrooms were used on a continuous, ongoing, and recurring basis. The rooms were available for day care use throughout each business day and were regularly used as part of Mrs. Rosales' business. Again, there is no requirement that day care children play in a room for it to be considered regular use in the business.

Time

	<i>Taxpayer position</i>	<i>IRS position</i>
Hours spent caring for children	2,541	2,541
Hours spent on business activities after day care children were gone	1,144	306
Total hours	3,685	2,847

On appeal, the Appeals Officer did allow 3,220.75 hours.

Family child care providers are entitled to count all hours spent in their home on business activities as part of the calculation of the home office deduction.

IRS Revenue Ruling 92-3 says that the calculation for the time percent is based on "...the total hours in the year that the day care business is operated (including substantiated preparation and clean-up time), divided by the total number of hours in a year."

The IRS MSSP Child Care Providers Guide (TPDS No. 85187M) says, "Hours spent cooking, cleaning, and preparing activities for the business of child care could be included in the calculation of the Time-Space percentage... As with any business use of a home, care providers must substantiate claims for hours expended in the conduct of the business of providing child care."

In the Neilson v. Commissioner case (94 Tax Court, January 2, 1990) the court allowed a family child care provider in Minnesota to claim 15 additional business hours each week

spent in preparation and cleaning activities when the day care children were not present in the home.

A study from the Wheelock College Family Child Care Project surveyed full-time providers in three states and found that they spent an average of 13.9 hours per week on business activities in the home after the children were gone (Economics of Family Child Care Study by Kathy Modigliani, Wheelock College, and Suzanne W. Helburn, John R. Morris and Mary L Colkin, University of Colorado, Denver).

Taxpayer kept daily records substantiating all of her business activities after the day care children were gone for the day. These records were made contemporaneously on a calendar (see attached). All of the activities shown on her calendar would not have been done except for the fact that she ran a family child care business. The IRS examiner refers to taxpayer's calendar as "unrealistic" because she worked 7 hours in April on laundry as well as another 4 hours on business activities that day. In fact, the examiner misread the calendar notation. Taxpayer claimed one (not seven) hours of laundry work that day. The day was April 7th and the examiner misread April 7 as 7 hours of laundry work. The IRS examiner also questioned time in April where the provider made a notation "unpack." This was time spent unpacking all of the materials she purchased at a state wide Association for the Education of Young Children conference in Des Moines, Iowa. She spent time putting the materials away in her garage and basement.

Attached is taxpayer's calendar showing the hours that Mrs. Rosales worked. The hours that the IRS hearing examiner did not allow are circled on the calendar. Some of the hours that the examiner disallowed were hours spent on laundry. The court in the Uphus and Walker cases specifically cited the use of a laundry room as a common activity in day care that allowed their basement areas to be counted as regular use. Certainly time spent on laundry for her 8 day care children is a reasonable business activity.

Mrs. Rosales also spent some time studying (including reading and computer time) for her classes to obtain her Early Childhood Degree. Although she did not attempt to deduct the cost of getting her Early Childhood degree (because this was her first post secondary degree) we believe she is entitled to claim the hours spent in her home studying for this degree. IRC section 280A does not say that hours spent on such classes cannot be claimed by a family child care provider in her home office calculation. These hours were spent learning skills that were then immediately applied to her business. The fact that the

cost of the class was not deductible does not change the fact that the time spent on this activity was a business activity.

Home Office Calculation

Because taxpayer has a room that is used exclusively for her business we must follow the special instructions to calculate the home office deduction that is found in the instructions to Form 8829. Based on these instructions and the above facts, taxpayer is entitled to a home office deduction of 45.5%.

Exclusive use room

220 square feet / 3,591 total square feet = 6.1%

Rest of home

3,371 square feet regularly used in business / 3,591 total square feet = 93.9% Space

3,685 hours spent in the home for business / 8,760 total hours in the year = 42% Time

93.9% Space x 42% Time = 39.4%

39.4% plus 6.1% = 45.5%

Class hours represent 2.6%. (226 hours)

Interest Expense

2001

Taxpayer position: \$809

IRS position: \$612

2002

Taxpayer position: \$906

IRS position: \$581

The IRS allowed an interest deduction on the van (\$612 in 2001 and \$581 in 2002). They disallowed all other credit card interest as personal. Taxpayer had a separate business

credit card where she purchased items for her business. See the attachment for records of these credit card purchases. We have also enclosed statements from her personal credit card so you can see that her business credit card was indeed used for business items.

This other interest was for the following purchases that were used in the taxpayer's business.

Supplies

2002

Taxpayer position: \$10,231

IRS position: \$6,833

Employee Benefit Program

See discussion above for Health Insurance Deduction (#1).

Accuracy Related Penalty

An accuracy related penalty is warranted when a taxpayer is negligent or intentionally disregards the rules and regulations when the taxpayer cannot establish that the underpayment of tax was due to reasonable cause. The taxpayer has shown reasonable cause for all of the above disputed items. The taxpayer relied on the professional advice of her tax preparer and there is no evidence that she intentionally disregarded any rules or regulations. There is no evidence of any connection between Mrs. Rosales and the Renaissance program that her tax advisor was involved in.