

Phyllis Rosales v. IRS Commissioner

Before the Tax Court Appeal

This audit began in January 2003, and the 90-day deficiency letter was sent on December 29, 2004. The trial date was set for April 2006 and we settled the case in March 2006.

I consulted with Mrs. Rosales by telephone during her audit and appeal to a hearing officer. The original auditor and hearing officer took positions that denied the provider thousands of dollars in deductions, so we spent a lot of time submitting evidence (Tax Court rulings, IRS publications, photographs, receipts, and other records) to argue our case. When the auditor appeared to ignore our evidence, Mrs. Rosales contacted the Taxpayer Advocates office for help. Although the Advocate was sympathetic to our case and contacted the auditor, nothing changed as a result of his involvement.

In my opinion it is always best to try to argue as forcefully as possible at the beginning of an audit in an effort to resolve the case without having to appeal. Although I have always found that IRS agents are more informed and reasonable the higher up you go, I don't like to quickly appeal if I find myself dealing with an auditor who is not paying attention to the tax laws. Audits are stressful on the client (as well as on me!) and cases can drag out for years. I have had many experiences where the provider was very insistent with the auditor and the auditor's supervisor and the weight of the evidence presented was able to overcome the auditor's initial position so that the case was resolved without an appeal.

In this case much of the evidence Mrs. Rosales presented was ignored and we had to appeal to Tax Court. I was particularly disturbed that the hearing officer did not understand tax law affecting our case. Although she did compromise slightly on a few issues in her meetings with Mrs. Rosales, she withdrew all of these compromises when preparing the deficiency letter. Hearing officers do have the power to do this, but it seemed to me that she was simply punishing Mrs. Rosales for being persistent and standing up for herself.

The Settlement Process Begins

Because of the thousands of dollars involved in the audit (over \$14,000) and because I

believed that the IRS was dead wrong on many of the issues, I recommended that Mrs. Rosales appeal to Tax Court. I represented her pro bono. Mrs. Rosales lives in Kansas City and I am in St. Paul, so I petitioned to move the trial to St. Paul. If there was a trial she could not afford to come but I knew that we would get another chance to make our case with an IRS attorney and I was hopeful that we could settle before the case went to trial. If we couldn't settle, then I was prepared to present our evidence to the IRS lawyer, submit a series of Stipulations of Facts, and let the judge rule based solely on this.

Two months before the trial date, I got a letter from the IRS lawyer asking to meet with me to discuss the case. She also sent me an informal discovery letter that identified each issue and asked me to present all evidence I had to support our position (facts, contentions, documents, legal theories, and testimony).

In my written response, I listed each issue in dispute on a separate piece of paper. I identified the IRS's position and our position at the top. Then I listed all the facts that supported our position as well as any relevant court cases. I also attached documents to support our position. (At our meeting the IRS lawyers said that my presentation of the facts and evidence was very helpful to them and made settling the case much easier.)

Although I knew that my client was not going to travel to St. Paul for the trial, I didn't want to let the lawyer know whether my client would appear or not. I assumed the lawyer would want to settle the case as much as I did but I didn't want to give any indication of this.

In meeting with IRS agents at any level in an audit, I always consider whether or not to take charge of the meeting agenda. Sometimes it makes sense to come prepared to be assertive up front and in other cases I found it works better to let the IRS set the tone and respond to their statements. In this case I considered telling the IRS that I believed my evidence was strong enough so that the burden of proof had shifted to them in an effort to put them on the defensive and push them to settle. But in general I prefer to initially take a non-confrontational stance and try to appeal to the reasonable nature of IRS agents, so I decided to let the IRS take the lead at our meeting.

I met with a paralegal and her supervisor, an Associate Area Counsel. I said at the beginning of the meeting that I hoped we could reach a settlement in this case. They agreed that they had the same goal. The paralegal proposed that we go through each issue

one by one and I decided to let her deal with the issues in the order she preferred.

Before meeting with the IRS at any stage of an audit, I try to identify what are the major and minor issues from my client's point of view. In this case the big issues were the medical reimbursement plan and the Time-Space percentage. If we could win these two issues, then I felt we would be able to settle all the other issues. I had previously asked my client if she was willing to give up some deductions that she was probably entitled to in order to resolve the case, and she agreed.

At the Settlement Meeting

Medical Reimbursement Plan

The first issue the IRS brought up was the provider's medical reimbursement plan. The provider had hired her 17-year-old daughter and her husband. The daughter worked 3 hours a day caring for the children and he worked 6 hours a month. Her husband actually worked more hours (23 hours a month) but the provider didn't track this carefully. Some of the hours he worked (mowing the lawn, picking up leaves, watering the yard and other household activities) should not have been considered as business work in light of the Speltz case. Providers should not be paying their spouse or children to do household activities that don't have a strict business purpose. Cleaning up after the children are gone, for example, would be considered a reasonable business activity. This issue might have been a problem in this case if the husband hadn't also spent a lot of hours on clearly business activities (repairing toys, cooking for children, providing substitute care, etc.) and if there weren't so many business hours worked by her daughter.

In addition to paying \$4,783 in salaries, the provider deducted \$2,925 in medical expenses and \$1,480 in medical insurance premiums. The salaries and benefits allowed came to \$10.78 an hour. If this hourly wage had been a lot higher, it might have been a problem without better records of his work hours.

The original auditor wrote in her report, "Mrs. Rosales told me that she had set something up with the payroll service saying that instead of offering her husband a health insurance plan, she would just reimburse him for medical expenses out of his pocket. I have found nothing in the Codes allowing this kind of set-up. Also the fact that the husband is a 'related party' makes the situation [not] allowable."

The provider had presented the auditor with a four-page medical reimbursement plan that she had established through a tax advisor in 1999. The fact that the auditor did not recognize such plans under Tax Code Section 162(l) is inexcusable. The fact that the hearing officer supported the auditor's denial of the deduction of medical expenses under the provider's plan is shocking. When a provider (or any other taxpayer) sets up a medical reimbursement plan for hiring a family member, it is reasonable for the IRS to question whether a proper employee-employer relationship has been established and whether the work performed was related to the business. Most taxpayers get into trouble because they did not keep adequate payroll records (job description, records of work hours, records of payment, etc.). In this case the provider had paid her husband and daughter a salary and had done the proper payroll withholding and filing of Form 941, W-2, and W-3. The auditor acknowledged in her report that there was a proper employer-employee relationship and that the work done was related to the business.

I don't have any explanation as to why the auditor and hearing officer did not acknowledge the possibility that the provider was entitled to use a Section 162(l) deduction. I don't know what else the provider could have done to avoid going to Tax Court to settle this issue.

In preparation for my meeting with the Tax Court lawyers, I was ready to argue that Mrs. Rosales was entitled to this deduction because she met the tests as described in the recent Speltz case:

Was there a valid medical reimbursement plan? Rosales had established a plan through a tax advisor. Notice or knowledge of the plan was reasonably available to her employees. She had established a bona fide employee relationship that was recognized by the auditor.

Were the deductible expenses ordinary and necessary? The daughter cared for the day care children 3 hours a day and enough of the husband's work was business related.

At the meeting with the Tax Court lawyers their first words were, "We concede on this issue because of the recent decision in the Speltz case." I didn't have to say anything.

Note: The Rosales tax preparer had claimed 60% of the health insurance premiums on Form 1040 instead of on her Schedule C. This mistake didn't matter as the Tax Court

lawyer did allow this as a deduction on Schedule C.

Business Use of the Home

The next issue the IRS raised was the Time-Space percentage. The provider claimed a 46% Time-Space percentage and the auditor would only allow 22%. This was a significant difference and worth fighting all the way to Tax Court because of impact this percentage had on thousands of dollars of deductions associated with the home.

The provider had a playroom that was used exclusively used in her business. She cared for ten day care children, and without a young child of her own at home (her daughter was 17) this was easy to assert. The auditor and hearing officer did not challenge this issue.

The provider claimed all of the rest of the rooms in her home as regular use in her business, including her basement and attached garage. The auditor denied the garage, the provider's bedroom, and daughter's bedroom. Initially the auditor would not allow the basement but after much argument by the provider the auditor did allow 25% of the basement (later raised by the hearing officer to 50%). The provider had submitted a copy of the Uphus and Walker Tax Court cases (I had argued these cases in 1994) that clearly set the standard for when providers can claim basements and garages.

In referring to why she would not allow the full basement as regular use, the auditor's first report said, "The storage portion of business use of the home applies to storage of inventory or product samples." This is a clear failure of the auditor to understand that the storage rule in claiming home office expenses is in Section 280A(c)(2) and that the rule for family child care rule is in Section 280A(c)(4). The hearing officer failed to correct this obvious error.

In a later report the auditor said, "Mrs. Rosales claims she uses 100 percent of the garage and basement for storage, however she also states that they have a washer, dryer, and freezer in the basement which in itself would void the 100 percent use. The garage is not heated or cooled." The established rule, Tax Code Section 280A(c)(4)(A), for calculating the business use of the home for a family child care provider is "regular" use, not "exclusive" use. This statement by the auditor shows again that she had no understanding of basic tax law. I cannot explain why the hearing officer did not understand "regular"

use under Section 280A, correct the auditor, and follow the Uphus and Walker cases to allow the provider to count 100% of her basement and garage.

In our letter to the Tax Court lawyers I provided photos of the basement and garage to show that it was regular use. We also provided a lengthy list of the business items stored in these two rooms. The case for the basement and garage was extremely strong because of the Uphus and Walker Tax Court cases.

The case for the two bedrooms was weaker. The provider bedroom was used for business in the following ways:

- Storage of marionette puppets and business file boxes
- Vanity desk and chair used to conduct record keeping once a week
- Sewing machine used every few months for craft projects
- Sick children in the room four times a year
- Children entered bedroom every day to get to a bathroom

The daughter's bedroom was used for business in the following ways:

- Provider entered room several times a day to take items from storage shelves in the closet used to store art supplies, paper, beads, etc.
- Storage of two children's folding chairs used once a month
- Provider entered the room each day to get a dust buster that was used by the children to clean up

Although I believe that the use of both bedrooms constituted "regular" use, I was prepared for the IRS to challenge our facts and argue that this was only occasional use. The Uphus and Walker cases state that there is no requirement that a child be in a room for it to be considered as regular use in day care. I know that some providers do claim bedrooms as regular use with fewer facts in their favor than this case. I believe that simply putting a few items in a room and calling it a storage room that is regularly used for business may be a difficult position to support in an audit. Although I thought it reasonable for Mrs. Rosales to claim these two bedrooms as regular use, I anticipated that the Tax Court lawyers might try to argue against the daughter's bedroom. If I had to compromise I would have conceded this room.

But the Tax Court lawyers accepted all of these rooms (basement, garage and both bedrooms) as regular use agreeing completely with our position. Again, I didn't have to

say anything.

Hours

The original audit did not challenge the number of hours the provider spent caring for children. The auditor focused on the number of hours the provider spent on business activities after the children were gone. (It is typical for the IRS to challenge such hours.) The provider claimed 1,144 hours after the children were gone, or an average of 22 hours a week. This is significantly higher than a national average of 13.9 hours a week (The Economics of Family Child Care Study, Kathy Modigliani, et al). In the Neilson case the provider was allowed to claim 15 hours a week on meal preparation, cleaning, and reorganizing.

The IRS auditor allowed only 306 of these hours. In my workshops I advise providers to keep careful records of these hours for at least two months each year. This case is unusual in that Mrs. Rosales tracked these hours on a daily basis for twelve months.

The auditor went through the provider's calendar and circled the hours that she would not allow. These hours included: laundry, computer work, cleaning, paying bills, etc. It appeared that the auditor did not think the provider was working so many hours and arbitrarily reduced some of the laundry and cleaning hours. Out of the original 1,144 hours claimed, the auditor also denied 297 hours the provider spent working at home on her Early Childhood Degree.

The Tax Court lawyers were willing to accept all 1,144 hours except those hours spent by the provider working at home on her Early Childhood Degree. This was the provider's first undergraduate degree, so the cost of her classes were not deductible. But I argued that the hours she spent in her home studying for this degree should count because it was clearly related to her business. That is, the knowledge gained from her studying was directly applied to the care of the children. The lawyers simply said that because the degree was not deductible, the hours shouldn't count. I replied that the issue of cost and hours are not always necessarily connected. I pointed out that the cost of paying someone to mow the lawn would be deductible (as well as the cost of the lawnmower), but that the hours spent mowing the lawn would not count as part of the Time percentage because this is not an activity that is done solely because of the business. Therefore, the issue of time and money are not always connected. But the IRS would not agree. This was an

issue I had never faced before and so I asked the lawyers if they had any authority to support their position. They didn't.

I had previously counted up the number of hours spent on the degree (297 hours, or 3.4% of the year) because I knew this would be disputed. The IRS was therefore offering to allow a Time-Space percentage of 42.7%, up from the auditor's original position of 22%, and so I felt that it was reasonable to accept their position as part of the settlement, particularly because we had won the previous two important issues of the medical reimbursement plan and the Space percentage. The Tax Court lawyers were accepting 847 hours of business activities after the children were gone. This represents an average of 16.3 hours per week. I have seen many audits where auditors challenged providers who claimed a lot less than 16 hours a week. The Rosales case can be used by providers and tax preparers to argue that it is not unreasonable to claim 16 hours a week for such hours.

Because the Time-Space Percentage affects so many other deductions, it is important to see that these other deductions are properly adjusted. After I received the final IRS report I looked closely to make sure that all items affected by the Time-Space percentage were properly adjusted. I have seen math errors made by the IRS at all stages of an audit, including on the final paperwork after another Tax Court trial.

In the end, we won the business use of home issues because of the thorough documents and Tax Court cases presented to the IRS before the meeting.

Repairs and Other Expenses

The provider had originally deducted 100% of the following items: cable television, cell phone, Internet fees, a telephone "works package," exterminator, duct cleaning, carpet cleaning, furnace cleaning, dryer repair, lawn mower repair, garage door repair, and Roto Rooter. The auditor had disallowed any deduction for the cable television, cell phone, telephone "works package," and Internet fees. I could not tell from the auditor's report whether or not the other items were allowed on Form 8829 (some were and some were not).

It is a common mistake for providers (or their tax preparers) to claim 100% for household items. A provider might claim that she is purchasing an item only because of her business

and therefore believe that she is entitled to deduct the full amount. In this case Mrs. Rosales had her carpet cleaned because state law required them to be professionally cleaned twice a year (we produced a letter from the state showing this). But it is more reasonable to look at how an item is used and not try to claim a 100% deduction unless the case can be made that the day care family never uses it. This is usually a hard case to make.

I proposed in my response to the discovery request that all of these expenses (with one exception) should be allowed as an allocated Form 8829 deduction, rather than 100% on Schedule C. They accepted this position without discussion. The one exception I argued was the duct cleaning expense. The provider cared for a child with asthma and only cleaned her ducts because of this child. I presented an analysis based on the amount of time business and personal people were in the home to arrive at a 60% business use. The Tax Court lawyers did agree that it was possible for a provider to claim a higher business use than their Time-Space percentage for one or more items, but they wouldn't back down on the duct cleaning. I asked what further evidence we might have presented that would have strengthened our case. They replied that we should provide a note from a parent saying that her child with asthma was in the provider's care and a letter from the child's doctor saying that the cleaning of the house ducts would be beneficial to the child. It had not occurred to me that the IRS might not believe the provider was caring for a child with asthma or that a doctor's letter would be helpful. Since we were so close to settling the case, I didn't want to take the time to try and get these documents, and given that the difference between our positions (60%) versus a Time-Space percentage of 42.7% was so small, I dropped my objection.

By this time in the settlement meeting we had resolved all of the major issues. I then brought up one small deduction that had been the source of great frustration for the provider. After obtaining her Early Childhood Degree, the provider spent \$30 to frame her diploma, and she put it on the wall in her front entry so her day care parents could see it. She saw this new credential as a means to promote her professionalism to her clients. The auditor had denied the deduction because she saw it as part of the nondeductible degree. The Tax Court lawyers also initially disallowed this deduction at our settlement meeting. I made the argument that the promotion of a degree should be deductible even if the degree was not. I then said that I recognized that this was a very minor deduction but that it mattered a lot to the provider. In this situation, when I couldn't convince the IRS based on the facts, I appealed to their sense of reasonableness and they finally accepted

this deduction. This small victory meant as much to Mrs. Rosales as anything else.

Depreciation

Mrs. Rosales claimed a 100% business deduction for her CD player, 2 rockers, computer, camera, dishwasher, and playhouse. It was a mistake to claim 100% for items also used by her family. In my discovery letter I proposed that we be allowed to claim the Time-Space percentage of these depreciable items, 100% of the playhouse and 100% of one rocker, and the Time-Space percentage of the other rocker. The lawyers, without discussion, accepted our position except for the rockers. They said they would allow the Time-Space percentage on both rockers.

The provider bought a rocker/recliner at a two-for-one sale for \$715 and used one of them exclusively in her business (rocking the children). Day care parents used the second rocker. She deducted 100% of this cost, even though her family also used the second rocker. The auditor denied any deduction for either rocker without any logical explanation. My discussion with the Tax Court lawyers focused on what we could do to prove that the provider used one of the rockers 100% of the time in her business. (I have always found it useful in discussions with the IRS to ask the question, "What can we do to prove our case?" Framing the discussion this way forces the IRS to give you useful information.) There is no good answer to this question (how can we prove that her family never used it?). The lawyers again acknowledged that it is possible to claim a higher business use percent than the Time-Space percentage, but they were reluctant to allow a 100% deduction on furniture that could have been used by her family. One of the IRS lawyers said that the rocker was "available for personal use," but I replied that this was not the test to use in determining if something was used exclusively for business. Finally I said, "How about 90%?" and they agreed. In discussions with the IRS, when I have reached the point where nothing more can be said and the IRS is still not agreeing to my position, I usually propose a compromise. Here it worked.

Roof

The auditor's report made an error in how it calculated the depreciation deduction for the roof of the provider's home. The report showed a \$2 deduction based on a \$7,000 roof expense depreciated over 39 years with a 22% business use. Even using these facts the deduction should have been about \$35, not \$2. The IRS lawyers quickly agreed that this

was an error. I always review the calculations on depreciation tables that auditors prepare to spot just these types of errors.

Travel

Mrs. Rosales traveled several hours from her home to Springfield, Ohio, to purchase leather craft supplies for her business. The auditor allowed the miles but not the cost of the hotel and meals. I submitted copies of her credit card statement showing a \$223 purchase at the leather store and a personal purchase of \$32. In addition, the credit card statement showed that she made another trip to Springfield in a different month that was not claimed as a business trip. On this second trip she made more personal purchases than business purchases. The Tax Court lawyers accepted our position without discussion.

The provider and her daughter made a trip to Hawaii to attend a child care conference for six days. She couldn't get a plane reservation close to the conference date and arrived in Hawaii six days before the conference began. She spent 33 hours on conference and business activities during the six-day conference. She spent an unspecified number of hours during the first six days buying items for her day care children and visiting sites where she brought back ideas to use in activities for her business. The auditor originally allowed the deduction for the provider's conference fee and her travel, but later denied the deduction for her travel and hotel. The auditor also denied the deduction for the daughter's travel and conference expenses and the meals during the six days of the conference.

The Tax Court lawyers initially would not allow the deduction for the provider's travel and for any expenses associated with the daughter. Although the daughter had worked 3 hours a day for the provider for several years, during the year of the Hawaii conference the daughter earned less than \$100 because she took a full time job. Her intention was to return to work for her mother the next year. Even though the provider's husband did not accompany her to Hawaii and even though there was a strong employment history with the daughter, the lawyers would not move on this point and I did not argue it in detail because we had won on so many other issues.

We had a long discussion about whether or not the primary purpose of the provider's trip was business or personal. The lawyers did not believe that the provider could not avoid arriving in Hawaii a week before the conference. The lawyers agreed that travel to a

conference would be considered primarily business under the following scenario: A taxpayer spends seven days away from home. Two of the days are for travel and she spends more than 20 hours (out of a 40 hour work week) on business activities for the other five days. I then argued that we have shown that the primary purpose of the six-day conference was business. We submitted conference certificates showing attendance at workshops and the length of each workshop. (Without records showing conference attendance, we would have had a hard time making our case.)

The provider was gone from home for 14 days. Two of these days were for travel. Six days were primarily for business. Six days were spent on vacation with some business activity. At this point I argued that the trip was 50% business and 50% personal. I then argued that if we could show that a few hours were spent on business activities for the other six days, we could make the case that the entire trip was primarily for business purposes. All we need to show is 51% business activity. I couldn't prove exactly how many hours were spent on business activities in the first six days, but I had presented a list of a number of activities that were business related. In the end the IRS agreed. At one point one of the lawyers said that maybe we needed to show that 51% of the 12 days was for business purposes. In other words, we would need to show that the provider worked more than 41 hours on business activity for a two-week trip. Since I did not want to discuss this interpretation, I ignored it and moved quickly to settle this point.

Supplies

Mrs. Rosales deducted \$10,231 of supplies. She purchased these items out of her separate business checkbook. She did not count some personal items on these receipts (food, soda pop, etc.). The auditor would only allow \$6,833 of these expenses and disallowed items such as cat litter, cat food, clothing, and other items deemed to be personal.

I mailed to the Tax Court lawyer copies of over 100 pages of receipts and cancelled checks showing these expenses. Because some of the copies could not easily be read I couldn't tell if they totaled the \$10,231 claimed. In an effort to compromise, I circled items that we would not claim (cat food and litter and some other items). These items totaled \$1,117. I knew that some of these items we were dropping should be allowed, but I did not want to open up a discussion that would look at every single item on the hundreds of receipts. The lawyers accepted our position without discussion.

Interest

The provider had a separate business credit card in addition to her personal credit card. She deducted 100% of the interest on her business credit card. For reasons that I can't explain, the auditor and the hearing officer would not accept any business interest deduction, even though the provider had produced copies of all the business credit card statements showing the items purchased were for her business. It appears that they believed that no interest expense could be deducted. After looking at these credit card statements, the Tax Court lawyers allowed this deduction.

Penalties

The auditor had tacked on accuracy related penalties of \$2,400, but the Tax Court lawyers dropped them without discussion at our meeting.

Conclusion

This case was settled after my three hour meeting with the IRS lawyers. They were reasonable and professional. After all the issues were resolved in our case, I asked how the settlement would be communicated to the auditor and hearing officer. They said they would send a report explaining why they took their position in the settlement. I said that I thought this case should never have gotten to Tax Court and that the auditor and hearing officer failed to do their jobs. I asked what they could do to admonish them, but they were not helpful in this regard. It was a frustrating experience to have the auditor and hearing officer ignore the law on issue after issue. I can only guess that they were ignorant of how tax law affected family child care providers, but there was no excuse for their conduct.

I have posted a copy of my notes that I used at my meeting with the IRS Tax Court lawyers here.

I continue to hear from providers and tax preparers who are being audited. I am happy to offer my assistance in such cases.