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Part III: Other Tax Issues

INTRODUCTION

The Business of Child Care

Family child care can be both difficult and rewarding. Few people give as much of themselves or accept more responsibility than the family child care provider. And few are more deserving of the satisfaction that comes from helping children learn and grow. As a provider, you know those difficulties and rewards well. However, there are other challenges that are equally important, to which you may not have given as much thought—such as dealing with parents, paying bills, making a profit, doing your taxes, and meeting government requirements.

Taking care of the children is only half your job. The other half is taking care of your business.

It is in your best interest to know as much about taking care of your business as you do about taking care of children. The parents who hire you will appreciate and respect it—and the Internal Revenue Service will demand it.

Since trying to follow all the advice in this book at once would pose a significant challenge for anyone, don't try to read this book from cover to cover. Instead, use it as a guide when you are looking for answers to specific questions about what is deductible and how to keep accurate records. Take your time. If you don't understand something, ask for help. If you try to improve your business skills a little more each year, your success will be assured.

Providing Informal Child Care

As a child care provider, you don't need to have a business name or be registered with your state or Chamber of Commerce in order to be considered a business. All you need to do is open your business and start caring for children. From the standpoint of the IRS, you do not have to be regulated in order to be in business and start claiming expenses.

If the local child care requirements are voluntary, or if you are exempt from them, you may claim all the same business deductions as a licensed or certified provider. For instance, your state may require providers to be licensed if they care for more than four children. If you care for three children, you will be exempt from licensing rules, but you will still be able to deduct the same business expenses as a licensed provider. (You may even claim many expenses if you are operating illegally. See page 87 for further details.)

Top Three Record-Keeping Tips

This book describes many record-keeping suggestions. Here are the three most important points to remember:

- Save your receipts for all the expenses associated with the upkeep of your home (this topic is covered in chapter 1).
- Carefully record the number of meals and snacks that you serve to the children in your care, including all the meals and snacks that are not reimbursed by the Food Program (this topic is covered in chapter 2).
- Track all the hours you work in your home (this topic is covered in chapter 3).

By carefully following these three suggestions, you can ensure that you will claim the most important business deductions that you are entitled to on your tax return. So if all the details in this book feel overwhelming to you, simply focus on these three things.

CHAPTER SIX

Deducting Your Home Expenses

Chapter Summary
This chapter lists the deductible expenses that are associated with owning, renting, and maintaining your home or apartment.

Home expenses are the costs that you incur to keep and maintain your home. You can deduct the business portion (the Time-Space percentage) of these expenses on **Form 8829 Expenses for Business Use of Your Home.** If you don't own a home, you can claim the business portion of any expenses you pay for your living quarters, such as rent, utilities, and renter's insurance.

There's a limit to the amount of home expenses you can deduct each year (except for the business portion of your mortgage interest and real estate taxes, which you can always claim in full, as described below). For example, you are not allowed to turn a business profit into a loss by claiming your home expenses. You will find out if you can claim the full business portion of your home expenses when you fill out **Form 8829,** since it shows you how to calculate the amount you can claim. If you cannot claim all your home expenses in a certain year, you can carry the remaining amount forward and claim it the next year. (For more information on **Form 8829,** refer to the *Family Child Care Tax Workbook and Organizer*.)

The home expenses that you can claim on **Form 8829** include the following:

- casualty losses
- mortgage interest and real estate taxes
- homeowner's insurance
- home repairs and maintenance
- utilities
- rent

This chapter also covers the expenses of moving to a new home, which may or may not be deductible as a business expense, depending on the situation. To claim these expenses, you would use **Form 3903 Moving Expenses.**

Casualty Losses

A casualty loss is the damage, destruction, or loss of property that results from an identifiable event that is sudden, unexpected, or unusual, such as an earthquake, tornado, flood, storm, fire, car accident, or act of vandalism. If your home or car insurance completely covers the damage you incurred, you don't have a business expense. However, if you have an insurance deductible of $250 and you pay this amount, it is a business expense.

Your casualty loss expenses must be multiplied by your Time-Space percentage unless the damaged property was used exclusively or to a large degree for your business. To calculate the value of the property you lost, use the fair market value of the item on the date you began using it for your business. If you have claimed any depreciation on the item during the years it was used for business, you must reduce its fair market value by the amount of depreciation you have claimed.

To prove that you did indeed have a casualty loss, you may have to reconstruct your records. That's why it's important to conduct a thorough inventory of all the items in your home and put a copy of this inventory in a safe-deposit box. (For guidelines on how to conduct a household inventory, see chapter 7. For a helpful logbook that you can use to track your inventory, see the *Family Child Care Inventory-Keeper*.) Other kinds of proof might include photos of the lost or damaged items and testimony from friends or relatives. To provide further evidence, you should also promptly report your loss to the police, the fire department, or your insurance company.

Here's an example of calculating a casualty loss: A storm damages your home. All but $1,000 of the damage is covered by insurance. Your Time-Space percentage is 25%.

- If all the damaged property was used both by your business and by your family, you could claim $250 as a business expense ($1,000 x .25).
- If $500 of the damage was to furniture that was used exclusively for your business, you could deduct $500 plus $125 ($500 remaining property x .25).
- If your business-use percent of the damaged property was 75%, you could deduct $750 ($1,000 x .75).

Related expenses that result from a casualty or theft, such as the treatment of personal injuries, temporary housing, or a rental car, may also be deductible as business expenses. For more information, see IRS **Publication 334 Tax Guide for Small Business.** Food that is spoiled and must be thrown away because of a power loss is deductible if you were intending to serve that food to the children in your care.

If you buy items to replace the property that was damaged or destroyed, these new items are capital expenses that must be depreciated, so it's important to save your receipts. (See chapter 7 for more information about depreciation.)

Mortgage Interest and Real Estate Taxes

You are always entitled to claim the business percent of your mortgage interest payments and real estate taxes on **Form 8829,** even if this creates a loss for your business. You will deduct your Time-Space percentage of these expenses on **Form 8829,** and if you itemize deductions, you can deduct the remainder on **Schedule A.** Here's an example in which the Time-Space percentage is 30%:

	Total Expense (100%)	**Deducted on Form 8829 (30%)**	**Deducted on Schedule A (70%)**
Mortgage Interest	$3,000	$900	$2,100
Real Estate Taxes	$4,000	$1,200	$2,800

Although you may be tempted to simply claim the total amount of these expenses on **Schedule A,** you cannot do this. You are better off putting as many expenses as you can on **Form 8829,** where they will reduce your net business income, which is taxed at a higher rate (because it includes Social Security and Medicare taxes) than your personal income. For more information, see the *Family Child Care Tax Workbook and Organizer.*

Homeowners Insurance

You can claim the Time-Space percentage of home insurance (including flood insurance), which provides you with financial protection in case of damage to your home. Other kinds of insurance policies (renter's insurance, liability, disability, medical, and car) are not included with the home expenses on **Form 8829** and may or may not be allowable as business deductions. For more information, see the "Insurance" section that starts on page 103.

Home Repairs and Maintenance

Home repair and maintenance expenses are the costs that you incur to maintain your home's present value and keep it in good condition. You can claim the Time-Space percentage of these expenses on **Form 8829.**

This category does not include the costs of repairs and maintenance to your personal property. These expenses are listed on **Schedule C.** For a discussion of claiming repairs and maintenance on personal property, see page 109.

There is a difference between home repairs and home improvements. Home repairs are expenses that you incur simply to maintain your home's present value; you can claim them in the year you incur them on **Form 8829.** Home improvements are expenses that increase the value of your home or prolong its useful life; you must depreciate these costs over a number of years. For an explanation of how to claim depreciation for home improvements, see page 136.

The following list gives a wide range of examples of deductible home repair and maintenance expenses.

Examples of Deductible Home Repair and Maintenance Expenses

- asphalt repair of driveway
- carpet-cleaning service
- central security alarm system (monthly fee)
- corner wall guards
- cupboard latches and locks
- deck staining
- dehumidifier
- electrical fuse replacement
- floor sanding
- furnace cleaning, inspection, repairs
- homeowner's association dues
- housecleaning service
- humidifier
- lead paint removal
- light fixture repair
- painting the interior or exterior of your home
- patching walls and floors
- pest control (termites, rodents, bats)
- plumbing repairs (leaks, frozen pipes, etc.)
- radon or lead testing and abatement
- roof shingle repair
- rubber stair treads
- screen repair
- service contracts for built-in appliances

Utilities

You can claim the Time-Space percentage of your utility expenses, unless you can show that your business-use percent of a particular expense is higher than that. For example, if you have no children of your own and only use the Disney Channel for your business, you can claim 100% of its cost. Some examples of utility expenses:

- cable television
- electricity
- gas
- kerosene
- oil
- propane gas
- recycling fees
- sewage disposal
- trash removal
- water
- wood

Rent

If you rent your home or apartment, you can claim the Time-Space percentage of the rent you have paid on **Form 8829.** If you also pay for your own utilities, you can deduct the Time-Space percentage of your utilities as well.

If Your Boyfriend or Girlfriend Owns the Home

The general rule is that you can't deduct a home expense unless you're legally obligated to pay the bill. For example, if the deed on your home is in your boyfriend's name, you can't deduct any mortgage loan interest, property tax, or house depreciation. (Consult with a tax preparer before adding your name to any deed or loan agreement, because of the possible consequences of gift taxes and taxes associated with the sale of a home. Ask about the impact on any state taxes as well.) If you're married, you can deduct all home expenses on **Form 8829,** even if your name isn't on the deed or loan agreement.

If you pay your boyfriend for your share of the home costs, you can call these payments "rent" and put them on **Form 8829.** The business portion of this "rent" would be a business expense. Your boyfriend would have to report this "rent" as income by filing **Schedule E.**

You can deduct costs for utilities, rent, and house insurance if your name is on the bill. You can also deduct any home repairs that you pay for.

If you live with your parents and do child care in their home, you can't claim mortgage interest, property tax, or house depreciation, because you aren't an owner of the home. You could only deduct utilities, rent, or house insurance if your name is on the bill. This rule applies even if you live in a home owned by your parents and they live somewhere else.

In a recent Tax Court case, the court said that a taxpayer could deduct house expenses even though the taxpayer was not the legal owner of the property. The court cited Reg. 1.163-1(h), which says: "Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness."

In this case, the taxpayer had an agreement with a relative who owned the property under which the taxpayer would pay all the expenses associated with the home directly to the bank. The court said that these payments were, in effect, payments of principal and interest to the relative and represented payments of indebtedness on the home. In other words, because of this arrangement, the taxpayer was taking responsibility as if he were an owner by making payments to the bank, and the court thus treated him as an owner in fact, if not in law, of the property.

Therefore, if you are living in a relative's home, you should prepare a written agreement with the relative that states that you are obligated to pay a certain amount each month to the bank on behalf of the relative. This will allow you to deduct your Time-Space percentage of these payments on **Form 8829.**

If you do this, your relative must report the interest that you pay the bank as interest income on **Form 1040,** and can claim this amount as an investment interest deduction on **Schedule A.** The net result will be no additional tax if she itemizes deductions on **Schedule A.** If your relative takes the standard deduction instead of itemizing, she will still have to report the interest as income (because you paid it on her behalf) and will not get the deduction on **Schedule A.** In this case, she will have to pay income tax on this interest.

Moving Expenses

If you move to a new home, you may be able to deduct a portion of your moving costs, but there are several restrictions. For one thing, the move must be closely related to your business or to your spouse's business—for example, you move because you are transferred by your spouse's employer or because you believe the new neighborhood will be better for your business. If your decision to move is based on personal reasons, you cannot deduct any moving expenses. If your moving expenses are reimbursed by another party, such as your spouse's employer, you can only deduct the expenses that were not reimbursed. To claim moving expenses, you must also meet these requirements:

- Your new home must be at least 50 miles away from your old home or apartment. (However, if you are in the military and you move because of a permanent change of station, you do not have to meet this test.)
- After the move, you must work in your new home for at least 39 weeks during the first 12 months and for at least 78 weeks during the first 24 months.

If you meet all the above requirements, calculate your moving expenses on **Form 3903 Moving Expenses,** and then transfer the deductible amount to **Form 1040.** You can deduct the following "reasonable" expenses:

- Moving costs for your family's household goods and personal effects, including the cost of packing, crating, and transporting your household goods.
- The cost of storing and insuring your household goods within any period of 30 consecutive days after the day your possessions are moved and before they are delivered to your home.
- Traveling to your new home, including lodging. If you use your car to transport your family or your belongings to your new home, you can claim either 12 cents per mile (2003 rate) or your actual expenses (such as gas and oil) if you keep accurate records. In either case, you can also deduct any parking fees and tolls incurred during the move. However, you cannot deduct any repairs, general maintenance, insurance, or depreciation for your car.

When you move, you must also notify the IRS by filling out **Form 8822 Change of Address.**

Using *Calendar-Keeper* Software to Report Your Home Expenses

To print out a tax worksheet of the home expenses listed in this chapter, go to "Reports" and print out the following reports:

- Report Topics: Tax Worksheet
- List of Reports: Form 8829 Worksheet