



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS:IT&A

SUBJECT:

This memorandum responds to your request for advice regarding the following issues.

ISSUES

1. Are payments from _____, _____, to family day care providers income from a trade or business?
2. Is _____ required to issue Forms 1099 to family day care providers who receive payments of \$600 or more per year?

CONCLUSIONS

1. Yes. Payments from _____, _____, to family day care providers income from a trade or business.
2. Yes. _____ is required to issue Forms 1099 to family day care providers who receive payments of \$600 or more per year.

FACTS

The statement of facts is based on information provided by government officials and the taxpayers, both in writing and verbally in meetings with District Counsel and District Director personnel.

The _____ administers a program of subsidizing day care for children from income eligible families and to children who are abused or neglected. Family day care homes are one of the types of facilities that provide such care. In family day care homes, which are registered with the state, the family day care provider takes care of from three to six children in the provider's own home.

On _____, the Internal Revenue Service issued a Technical Advice Memorandum (TAM) which concluded that _____ payments to family day care providers were made solely to reimburse the providers for incurred expenses, that the providers were not engaged in a trade or business, and that the _____ was not required to file information returns to report payments to the providers pursuant to I.R.C. § 6041. The conclusions of the TAM were essentially reiterated in Situation 1 of Rev. Rul. 77-279, 1977-2 C.B. 12.

Nonetheless, on _____, the _____ informed _____, in essence, that payments to a day care provider of \$600 or more per year should be reported on Form 1099. Subsequently, _____ began to issue Forms 1099 to report payments to family day care providers. Since _____, _____, individual providers (who will be designated hereafter as "the taxpayers") and legislators have requested determinations from the Service of whether the 1974 TAM or Rev. Rul. 77-279 still apply to the _____ payments to the family day care providers. The taxpayers assert that the _____ payments continue to be no more than reimbursement for expenses incurred in providing day care to children in the program, that they have no profit motive but to provide family day care solely from charitable impulses, that they are not operating a trade or business, and that, therefore, _____ is not required to report the payments to them on Forms 1099.

The taxpayers are family day care providers who have contracts with the _____ to furnish day care for children from income-eligible homes and for children who have been neglected or abused. The taxpayers are about _____ out of _____ registered family day care providers in _____.

The family day care provider sends _____ a monthly bill, and _____ pays the provider the rate for that category of child care. If the provider charges more than the rate paid by the _____, the parent must pay the additional amount (unless the parent qualifies for assistance). All providers may care for children who are not

part of the program whose parents pay the full cost of care as well as children who are part of the subsidized child care program.

The method by which the family day care payment rate is set has varied. Before , rates were determined in accordance with the availability of budget monies; roughly speaking, the amount of money available was divided by the number of children to be cared for. Since , the federal government has given states annual block grants for child care. A state must conduct a survey every 2 years of the rates that regulated child care providers in a particular category actually charge parents and establish a "market rate" at the 75th percentile of such charges. A state may then reimburse its social services districts, such as , for payments to family day care providers up to the market rate. A district may choose to pay its providers more or less than market rate, but the state may reimburse it only for the lesser of the amount actually paid for child care or the state market rate.

The survey includes profit-motivated child care providers. Therefore, the rates, which are based on the actual cost to parents of unsubsidized day care, reflect the cost of wages (including salaries to owners) and overhead as well as out-of-pocket expenses such as food, supplies, and equipment.

The State market rates, which are the per diem payment rates used by , are as follows:

<u>Type of Provider</u>	<u>Range of Rates</u> (varies by age of child)
Day Care Centers	\$ - \$
Family Day Care	\$ - \$
Group Family Day Care	\$ - \$
In-home Care	\$ - \$

Although the market rate that applies to the taxpayers is \$, the providers who have contracts with most recently have been paid only \$ per day. The taxpayers cite this discrepancy as evidence that they are only being paid an amount sufficient to reimburse them for out-of-pocket expenses, in accordance with the TAM. However, officials have stated that, in the past, the lower rate was due to budget limitations, that there has been a lag since in raising the rates for the contract family day care providers, and that they expect that the contract providers will be given the same rate of pay as all other providers in that category of care after the cost survey is completed. Even at \$ per day, some taxpayers, who care for as many as six children 5 days per week, are receiving as much as \$ per week or approximately \$ per year from

Some taxpayers have claimed that their expenses in connection with providing family day care services include \$ to \$ a year for food, a swimming pool (\$), air purifier (\$), living room furniture (\$), refrigerator (\$) and roof replacement (\$). According to the Bureau of Labor Statistics, the average annual cost of food for a family of 5.6 persons in the United States is \$7,177.

All other social services districts in State issue Forms 1099 to report payments to family day care providers.

LAW

Section 61(a) defines gross income as all income from whatever source derived.

Section 6041 requires all persons engaged in a trade or business and making payment in the course of the trade or business to another person of gains, profits and income of \$600 or more in a taxable year to make an information return. Treas. Reg. §§ 1.6041-1(b)(1) and (g) provide that payments made by a state or a political subdivision are subject to this reporting requirement. Pursuant to Treas. Reg. § 1.6041-1, returns under section 6041 must be made, in general, on Forms 1096 and 1099, and a copy furnished to the payee.

As used in section 6041, the term "gains, profits, and income" means gross income. Thus, a payor would not be required to make a return under section 6041 for payments that are not required to be included in the recipient's income.

Section 162(a) allows a deduction for the ordinary and necessary expenses paid or incurred in carrying on a trade or business. In Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987), the Court stated that:

[T]o be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and ... the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

The Court rejected a requirement that the taxpayer must offer, or hold himself out as offering, goods or services to the public in order to be engaged in a trade or business.

Treas. Reg. § 1.274-5T(h) provides, in general, that an independent contractor that substantiates expenses for travel, entertainment (including meals), gifts or listed property to a client or customer in the manner provided in Treas. Reg. § 1.274-5T(c) may exclude reimbursement for such expenses from income. Reimbursement for expenses under other circumstances must be included in

income under section 61(a) and the expenses deducted under section 162(a) (if otherwise qualified).

Situation 1 of Rev. Rul. 77-279 holds that a day care provider who was reimbursed by a charitable organization for out-of-pocket expenses incurred in caring for children placed with the provider by the organization had no profit motive, did not in fact make a profit, was not employed by the organization, and was not engaged in a trade or business. Therefore, the payments were not includible in gross income so long as they did not exceed expenses, the provider was entitled to a charitable contribution deduction for unreimbursed expenses, the expenses were not deductible as business expenses, and the payments were not subject to employment or self-employment taxes. In contrast, Situation 2 of Rev. Rul. 77-279 involves an individual who was not held out to the public as engaging in day care work, but received a fixed weekly fee for caring for a child on a daily basis while the parents were at work. There was no agreement that a portion of the fee was a reimbursement for expenses. The ruling holds that the day care provider had a profit motive and was engaged in a trade or business. It concludes that the entire amount of each payment received by the individual from the parents of the child is includible in the individual's gross income.

ANALYSIS

Taxpayers argue that they are providing family day care solely out of charitable motivations, they are not in a trade or business, and they are being paid by _____ only for their out-of-pocket expenses. Accordingly, they argue that they should not be required to include payments from _____ in income and _____ should not be required to report the payments on Forms 1099. They rely on the _____ TAM and Situation 1 of Rev. Rul. 77-279 for these legal and factual conclusions.

Taxpayers' reliance on the TAM is misplaced. The TAM was issued to _____. A TAM may not be relied on by any taxpayer other than the taxpayer for whom it is issued. Rev. Proc. 99-2, § 17.01, 1999-1 I.R.B. 73, 96. Additionally, a taxpayer may not rely on a TAM after the law or facts have changed. Rev. Proc. 99-2, §§ 17.04 and 17.05, 1999-1 I.R.B. at 97. The material facts concerning payments by _____ to family day care providers, including taxpayers, have changed substantially since the TAM was issued. Accordingly, the TAM has been rendered obsolete and should be given no effect.

On the other hand, Rev. Rul. 77-279 is a precedent of general application that may be relied on and used in the disposition of other cases in which the facts and circumstances are substantially the same. However, based on the information provided, we conclude that the facts applicable to taxpayers differ significantly from

the facts in Situation 1, and are more akin to the facts of Situation 2 of Rev. Rul. 77-279.

Taxpayers are paid at a rate that is based on a survey of rates charged to the public by family day care providers generally. Many of these providers have included the cost of services and, in some cases, profit, in addition to out-of-pocket expenses, in establishing their rates. The actual market rate is then set at the 75th percentile of the rates charged, substantially above average. It is therefore reasonable to conclude that the market rate is sufficient to cover the cost of services or profit, as well as out-of-pocket expenses, for most family day care providers.¹

Although taxpayers have been reimbursed at less than the market rate, the discrepancy apparently has been an oversight and is to be rectified in the future. Even at the lower rate, however, some of the taxpayers have received almost \$ _____ per year from _____. The expenses that taxpayers have attempted to offset against these receipts to support their contention that they do not make a profit are, in many cases, excessive or unreasonable. The fact that taxpayers may charge some parents more than the _____ rate and may also provide care for private pay children also supports a conclusion that taxpayers are engaged in a trade or business.

Several of the taxpayers have argued that _____ regulations prohibit reimbursement to them for more than their expenses. For example, Code of Rules & Regulations § _____ states in part:

Payments by a social services district for child day care, informal child care and legally-exempt group child care are subject to reimbursement only when the following requirements are met:

(1) Payments do not exceed the actual cost of such care.

However, _____ officials have stated that the "reimbursement" referred to in this regulation is not reimbursement of the provider by the _____, but is reimbursement of the _____ by the State. In other words, the purpose of the regulation is to limit reimbursement of the social services district (_____) for the payments it makes to family day care providers to the lesser of market rate

¹ The taxpayers have not claimed that they are substantiating expenses in accordance with Treas. Reg. §§ 1.274-5T(c) and (h) or that the out-of-pocket expenses they assert are covered by the _____ payments are limited to the types of expenses addressed in that regulation.

or the actual amount paid, *not* to limit the amount of the payment to the providers to reimbursement for their out-of-pocket expenses.

This interpretation is supported by § _____ of the _____ regulations, which defines "actual cost of care" as:

... the rate usually charged by the caregiver for non-subsidized child care services. When child care services are provided in accordance with the terms of a contract between a social services district and the caregiver, the negotiated contract rate is the actual cost of care for such services even if such rate is less than the rate usually charged by the caregiver for non-subsidized child care services.

Additionally, a _____ Administrative Directive of _____, on child care market rates, _____, states at page 3 that "The actual cost of care is the usual rate charged by the provider for non-subsidized care."

Accordingly, we conclude that "actual cost" in the regulations refers to the cost to the _____ (i.e., the amount the _____ pays the providers) for purposes only of its payments from the State, not to the out-of-pocket expenses of the providers for purposes of the payments to them by _____. The regulations do not limit payments to the providers to reimbursement for out-of-pocket expenses.

We are therefore unable to conclude that the _____ family day care program payments are no more than reimbursements to family day care providers for out-of-pocket expenses. To the contrary, the rates of payment to taxpayers are based on the cost of family day care services to the general public and are intended to provide essentially a fair market rate of compensation. We cannot speculate on the charitable versus profit making motives of taxpayers, but the facts indicate that taxpayers are paid more than their out-of-pocket expenses and, therefore, are in a position to make a profit. Therefore, we conclude that taxpayers, in general, are engaged in a trade or business. Accordingly, the _____ payments should be included in the family day care provider's income.

This conclusion does not preclude the possibility that an individual taxpayer may not be profit-motivated or make a profit. However, because the family day care program rates are established at a level that is, at the very least, sufficient to compensate taxpayers for the value of their services, _____ is required to report payments to family day care providers on Form 1099.

Thus, we conclude that, in general, taxpayers are engaged in a trade or business and must include in income the _____ payments they receive. _____ is required to report payments to taxpayers for day care services on Form 1099.

If you have any further questions, please call the branch telephone number.

Deborah A. Butler
Assistant Chief Counsel (Field
Service)

By: Clifford M. Harbourt
CLIFFORD M. HARBOURT
Senior Technician Reviewer
Income Tax and Accounting Branch
Field Service Division