

Sy Accountancy Corporation

Member, American Institute of CPAs

704 Mira Monte Place, Pasadena, California 91101

Tel (626) 744-0200 • Fax (626) 744-0300 • vsy@victorsycpa.com • www.victorsycpa.com

HOME OFFICE DEDUCTION - BASIC RULES

By Victor Sy, CPA, MBA

Faced with traffic congestion and environmental concerns, more and more people are setting up shops at home. The last few years have seen a dramatic rise in the number of taxpayers using their homes for businesses and appropriately taking deductions for the business use of their homes. It has always been a good idea. It has also invited audits. Recent developments, however, have led more and more taxpayers to take this risk. Even the IRS has acknowledged this trend by including a separate line in Schedule C (income from business or profession) for home office deductions.

What was lost in the Soliman case was restored by the Taxpayer Relief Act of 1997, and more. The new law expands the definition of “principal place of business.”

A home office qualifies as a taxpayer's principal place of business under the Act if:

1. The office is used by the taxpayer to conduct administrative or management activities of the taxpayer's trade or business; and
2. There is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

With this provision, Congress effectively overturned the U.S. Supreme Court's decision in Soliman case in favor of taxpayers.

Planning Note: The expanded definition of a principal place of business that converts non-deductible commute to deductible mileage enables many taxpayers to deduct the travel to and from their homes.

Let us learn a few things about offices at home and how to deduct related expenses:

1. **Tests for deductibility:**

- A. The space must be used in a trade or business on a regular (continuing) basis.
- B. There must be an exclusive use of that area as a principal place of business, a place to meet with customers, clients, and patients.

2. **How to figure the deduction:**

- A. Measure the area used exclusively for business and the total area of your home.
- B. Divide the area used for business by the total area of your home to arrive at a business-use percentage.
- C. Apply that business-use percentage to items that could be deducted whether or not the home is used for business such as interests, taxes, and casualty losses.
- D. Deduct in full direct expenses of the business such as office supplies, business telephone, wages, depreciation on business furniture and equipment.
- E. Apply the business-use percentage to indirect expenses such as maintenance, repairs, utilities, and insurance.
- F. Do not deduct gardening, landscaping, pool service cost, or other costs that have no relationship to the office at home.
- G. The total of indirect expenses cannot increase a loss from the business. Deductions in excess of the current year's limitations may be carried forward to future years.

3. **Where to Deduct:**

- A. Self-employed taxpayers deduct home office expenses on Schedule C.
- B. Attach a new Form 8829 to your tax returns.
- C. Employees report such expenses on Form 2106 (employee business expense) which end up on Schedule A (itemized deductions) either as tier one (interest and taxes) or tier two (miscellaneous deductions which are subject to the two-percent rule).

4. **Special tips for special situations:**

- A. Self-employed taxpayers are those that are in business for themselves or those that receive 1099s with no withholding instead of the usual W2.
- B. The term "home" includes a house, apartment, condominium, mobile home, or both. It should also include detached garage, studio, barn, or green house.
- C. A separate structure such as a studio, garage or barn does not have to be your principal place of business or the place where you meet patients, clients, or customers. You may operate a floral shop in town and grow plants in a green house behind your house. Since the green house is used exclusively and regularly (the two magic words) for business, you can deduct the expenses even if it is not your main place of business.
- D. A day-care facility does not have to comply with the exclusive-use test if you comply with state requirements and you are in the business of providing day-care for children, persons 65 or older, or persons who are physically or mentally unable to care for themselves.
- E. The area does not have to be used exclusively if it is used for the storage of inventory if your home is the only fixed location for your trade or business and the space is separately identifiable as a storage area.
- F. Management of your investment portfolio is never considered a trade or business and, therefore, you cannot take home office deductions. In a recent tax court case, an anesthesiologist was allowed home office deductions because it was shown that the administration of his business was an essential activity and that the only office available for him was his home office. Anesthesiologists usually have no other office space.

5. **Depreciation:**

- A. If you depreciated the office area of your home and sell your home, you are supposed to recapture that depreciation, bring down your basis, and in effect, pay tax on it.
- B. TIP: The law allows you not to recapture the depreciation if you did not use the area for home office in the year of the sale.
- C. PLAN: It is therefore important to plan not to use the home office and not claim any related deductions in the year of sale. It would be foolish to do otherwise.

6. The Small Business Act allows home office deduction if you use part of your home to store product samples used in your trade or business.