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HOME OFFICE DEDUCTION UPDATE

By Victor Sy, CPA, MBA

Do you work at home? If you are one of millions of taxpayers who are self-employed, telecommuters, or employees, read on and learn the changes to various rules affecting your tax deductions.

First, let's revisit the Soliman case that caused most of us to lose home office deduction, learn how the Tax Relief Act gives back the lost benefits, and discuss how to deduct expenses for working at home.

With increasing traffic gridlock in many areas, the lure of starting home-based business or telecommuting has grown dramatically over the last few years. Self-employment refers to people who work at home as sole proprietors. Telecommuting refers to people working at home but access and share information using telephones, computers and fax machines.

The Soliman case in 1993 effectively took home office deductions away from us. Soliman was a self-employed anesthesiologist who practiced at different hospitals but was not provided with an office by any of them. He used a room in his home exclusively on a regular basis for contacting patients, doctors, insurance companies, doing bookkeeping, correspondence, and reading medical journals. He deducted expenses relating to his home office, claiming the room was his principal place of business. The Supreme Court rejected his deductions reasoning that his home office was not his principal place of business. The Court espoused a two-part test to determine whether the home office was the taxpayer's place of business. The relative importance test and the time test caused many small businesses to lose their home office deductions.

Outraged by complaints from taxpayers, Congress passed the Taxpayer Relief Act of 1997 that took effect in 1999. New rules make it possible for more taxpayers to deduct home office deductions by expanding the definition of a principal place of business. New provisions do not eliminate the old test but expand them to include home offices to be used for administration or management activities. A home office will be deemed your principal place of residence if you use it exclusively and on a regular basis for management of business and there is no other location where you conduct a substantive portion of your activities.

Let's analyze the new rules:

1. Regular use means that you must use a portion of your home as an office on a continuing basis.
2. Exclusive means that you must use a specific portion of your home only for business purposes. Personal use, even after business hours, causes the cost of maintaining the office to become non-deductible. (There are only two exceptions to this exclusive use rule: Storage of inventory and daycare facilities. Space in the home used for these two purposes can also be used for personal purposes).
3. While the regulations do not require a separate room, I suggest that you comply with this provision because the IRS has not let up in scrutinizing home office deductions. 4. You may deduct direct and indirect expenses. Direct expenses include repairs made to the room used for business and are deducted in full.
5. Indirect expenses benefit the entire home. These include utilities, mortgage interest, property taxes, and depreciation. **TIP:** Do not leave your computation a mystery that could lead to the audit of your tax return. Attach a diagram of the floor plan of your house and identify the office. Indicate the dimensions and show how you computed the square footage of the business portion and the eventual application of the business percentage to the total indirect expenses.

6. If you plan to sell your house and expect a profit, discuss the wisdom of depreciating the home office with your tax adviser. Such depreciation is “recaptured,” meaning that you have to pay tax on prior depreciation. More important, the portion of the home used as an office affects your \$250,000 (\$500,000 for married couples filing joint returns) exclusion of gain on the sale of your principal residence.
TIP: If you expect a relatively small benefit from the home office deduction, it might be better not to claim such home office deduction as you might end up paying tax on the depreciation recapture and losing some on the exclusion of gain on the sale of your principal residence. In short, you could end up paying more than what you save.
7. Home-based computers and related equipment are fully deductible for self-employed individuals if you solely use them for business at your qualifying home office. Claim the deduction by depreciating it under the MACRS (Modified Accelerated Cost Recovery System). You may also choose to expense the whole cost instead of depreciating it over five years. If your work space does not qualify as a home office, your computer becomes a listed property meaning that you can only claim to expense the whole cost (Section 179 Deduction) or use the accelerated depreciation method if business use is more than 50%. If the business use is 50% or less, you cannot use the Section 179 expense deduction and can only depreciate it on a straight line basis over five years.
8. There are special rules for deducting the cost of software (computer programs). When both computer software and hardware are acquired together and the software's cost is not properly stated, the entire purchase price is treated as hardware cost and depreciated over five years or expensed under Section 179 for the current year. If the software is purchased separately or its cost is separately stated, it is depreciated over 36 months. The current expensing under Section 179 does not apply. **CAUTION:** Software that are substantially modified and acquired in connection with the purchase of the business has to be amortized over 15 years (Section 197 Intangibles).
9. Office furniture can be depreciated under MACRS or as a Section 179 expense to the extent it is used for business purposes. They are not listed property and the business portion can qualify for the accelerated-MACRS depreciation in Section 179 even if such portion is less than 50%.
10. The cost of driving from your personal residence to your place of work is called commuting, and is a personal non-deductible expense. However, if you have an office at home, that personal commute becomes business transportation and you can deduct costs of getting from your home to other work locations. This is a big extra benefit for having an office at home as it converts a personal non-deductible expense to a deductible business expense.

The advantages of having a home office works especially for the self-employed rather than telecommuting employees. Employees generally do not enjoy such benefit as their expenses end up in Schedule A Itemized Deductions and are allowed only to the extent that they exceed 2% of the taxpayer's adjusted gross income.

In Conclusion, the home office deduction is back! After years of being dampened by the Soliman case, the Tax Relief Act relaxed the rules so that a home office can now qualify for a deduction if it is used for managerial or administrative purposes even though the income-producing activity is performed elsewhere. Structuring the business so that the home qualifies as a principal place of business yields additional deductible transportation expense that converts the non-deductible commuting expense to a deductible transportation expense. Computers used in that home office can also avail of the accelerated MACRS depreciation and the Section 179 Current Expense Deduction. Prepare a layout of the house highlighting the office space and discuss it with your tax preparer who can advise you on the allocation of utilities, home insurance, repairs, as well as mortgage interests and property taxes. While these last two items can be deducted in your Schedule A expense, it is worthwhile to know that deducting it as a business expense saves about 15% of FICA and Medicare.