Home Office

With the increasing use of computers, modems, and job sharing, more and more people work from their homes. Whether you are self-employed or work for someone else, the home office can give extra deductions on your tax return, **but** create extra headaches when you sell your home.

Requirements

The Internal Revenue Code allows taxpayers to claim a deduction for expenses incurred in operating a business from their home if they meet certain requirements.

This home office must be used **regularly and exclusively** 1) as the principal place of business for a trade or business; 2) as a place to meet with patients, clients, or customers in the course of the trade or business; or 3) in connection with the taxpayer's trade or business if the location is in a separate structure not attached to the dwelling unit. The "regular and exclusive" requirement does not have to be met if you are operating a day care business in your home.
In addition, if you are an employee, the business use of your home must be required by your employer for his/her convenience. Prior to 1999, the courts had interpreted the "principal place of business" very narrowly and disallowed a deduction if the office was only used for administrative and management activities rather than for the actual generation of income. However, the Taxpayer Relief Act of 1997 changed this, effective 1/1/99. Now a deduction for an office used only for those activities is allowed if there is no other location available to perform them.

In addition, a deduction may be allowed for inventory storage if the product is regularly sold to others and there is no other fixed location available for the business.

Calculations

The expenses that are considered when making the home office calculations include both direct and indirect expenses. Direct expenses are things that pertain exclusively to the home office, such as painting the walls or putting in new carpeting. Indirect expenses are those that pertain to the entire residence, such as rent, mortgage interest, taxes, insurance, repairs, utilities, casualty losses, and depreciation. Indirect expenses must be allocated between the business and non-business portions of the home.

The most accurate method of allocation is to divide the square footage of the office by the total amount of **usable** space in the home. If rooms are of approximately equal size, you can divide the number of rooms used for business by the total number of rooms.

In the case of a day care business, you multiply this business percentage by the fraction obtained by dividing the number of hours the home is used for business by the total number of hours in the year (8760 hours except in leap years).

Once these figures are known, the indirect expenses are multiplied by the business percentage in order to apply the limitations.

Limitations

The amounts of expenses that can be deducted are subject to specific limitations and ordering provisions. The overall limitation is based on the taxpayer's net income from his trade or business. For an employee, this is wages less other business expenses on Form 2106. For a self-employed person, this is the net income on Schedule C without the home office deduction. If there is a loss, no deduction is allowed and the expenses are carried forward to future years when there is net income.

However, three deductions are allowed in full regardless of the net income limitation. Mortgage interest, real estate taxes, and casualty or theft losses are allowed under other code sections and may create a Schedule C loss. They must be claimed in full before using any other expenses.

Once net income has been reduced by the otherwise deductible expenses, the other business expenses are deducted. If there is still net income at that point, depreciation is deducted. Any time the net income reaches zero, the balance of the expenses is carried forward. If the taxpayer goes out of business before using these amounts, they are lost.

Sale of Property and Excludible Gain

When you sell the home that had been the location of your home office, new problems can arise.

First of all, if you have used part of your residence for business purposes, that part is no longer a principal residence. This means you cannot exclude the gain on that part **unless** is had **not** been business property for more than two years in the five years prior to the sale.

Secondly, the depreciation allowed to be claimed on your home office is subject to taxation even if it meets the personal use rules. This depreciation is considered “unrecaptured Section 1250 gain” and will be taxed at a maximum rate of 25%.

These potential tax situations are avoided if you are renting your principal residence.

Planning considerations

The home office expenses can represent a significant dollar amount in computing your tax liability. If you think your situation meets the requirements, talk to your tax advisor for more specific details on how to quality for this deduction.

Not every item in our library will be applicable to your situation. If you need further advice, please feel free to give us a call any time at (608) 756-5354. Summit Accounting Group Inc. of Janesville, Wisconsin

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