

Home Offices: Revisited For 2013

by

David L. Gorsich, EA

Dave is a teacher since 1962, and a “tax guy” since 1977. His approach to individual taxation topics is often unique and a bit humorous, but “on point” with the law. He likes to take a “familiar” topic and show you a few things you never quite realized. So - - - pay attention!

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OVERVIEW

Internal Revenue Code Section 280A allows a limited deduction for use of your home in your business. Filing rules depend upon the Taxpayer's trade or business: Schedule C filers claim the deduction on Form 8829. Others use a worksheet and transfer the results to different Forms: Employees claim their deduction on Schedule A, Schedule F filers use Schedule F, and Partners transfer the result to Schedule E.

In January 1993 the Supreme Court rendered a decision which alters the way we look at who qualifies for the deductions. In August 1997 Congress changed the words of the law, effectively overruling the Supreme Court! For 1999 and later years, the qualifications for claiming the deduction are more liberal.

In 2012, IRS announced a new "Safe Harbor" method, with a simplified "\$5 per square foot" method.

Unfortunately there are several other problem areas. When selling a residence the Sec. 121 exclusion is a boon to homeowners, a bane to those whose home is partly a business establishment. Today we'll take a look at a few of the problem areas. In particular we'll look at:

- What Section 280A really tells us
- Who can claim a home office?
- What is "allocable" to the business use of the home?
- Problems with interest deductions on Form 8829.
- New "Safe Harbor" method – Helpful? Hurtful?
- Sales of the Residence.
- Interplay between commuting expense and home offices.

WHAT SECTION 280A SAYS

QUESTIONS: I WANT TO DEDUCT - - -

1. **HIGH ELECTRIC BILLS.** I run a furnace in my garage to produce special metal alloys for my machine shop. This furnace accounts for nearly 80% of my electric bill. I want to deduct this on my tax return.

2. **SECURITY SYSTEM.** I keep sensitive computer backup data and records for my financial planning business in my home. Because of this, I have installed an expensive security system, and want to deduct part of the cost.

3. **STORAGE.** I'm a tax practitioner. I maintain a commercial office, but it's small. I store most of my supplies and old tax returns at home. I want to deduct part of the costs of my home.

4. **MY FILE CABINET.** I do some work at home, and purchased a file cabinet to store the paperwork. The cabinet is in my den. May I deduct its cost?

5. **INTEREST AND TAXES.** I devote about 10% of my home to my business. I don't meet the "home office" rules, but since I cannot use this 10% for living purposes, I want to deduct 10% of my interest and taxes on my Schedule C.

ANALYSIS AND ANSWERS – I WANT TO DEDUCT - - -

TAX PRACTITIONERS KNOW LOTS OF RULES - - - BUT - - - . You probably looked at the questions on the prior page as "tax people". Your mind probably flashed some of the standard "justifications" for deductions, like "ordinary and necessary", "directly related", or "effectively connected".

NEGATIVE CODE SECTIONS. Sections 261 through 280H are devoted to listing items that are *not deductible*.

CODE SECTION NUMBERS. New Code sections get a number, like "XXX" among related sections. As the section is refined, "subsections" are added, like "XXX(a)", "XXX(b)", and so on. Occasionally an entirely new concept arises which is very similar to an existing idea. When this happens we see a "new" Code Section, named "XXXA". For example, when the IRA was

invented, it drew Section 408. Later came the SEP-IRA, given 408(k), and others. In 1997 Congress invented the Roth IRA – it's not really an IRA or retirement vehicle, because of the “not taxable” feature, but is so similar to the IRA that Congress invented a totally “new” Code Section – 408A.

THE “280” CODE SECTIONS. Section 280 was repealed in 1986 – it dealt with non-deductible costs in film, book, or record production. 280B limits deductions in the case of demolition of a structure. 280C limits deductions if a tax credit is available for the same expense. 280E says no business deductions at all if the business is selling illegal drugs. 280F limits deductions for “luxury” cars – the familiar “caps”.

280A DEALS WITH YOUR HOME. Generally, no “personal” items go on the tax return. The Treasury Department enforces the Internal Revenue Code. The Code looks at you and I more like machines than as people. (That job belongs to Health, Education & Welfare!). It allows for expenses of putting our minds, bodies, or capital to work. Over time Congress added a few “personal” items to the Code: medical deductions (if unusually high), contributions (part of our goal as “one nation, under God, with liberty and justice for all” or supporting “life, liberty, and the pursuit of happiness”), plus mortgage interest (with limits) and property taxes.

THE CODE ITSELF. Here are the opening sentences of Section 280A. Note the negative tone promised above:

1) SECTION 280A OPENS WITH a long sentence:

(a) General rule. Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

NO DEDUCTIONS CONNECTED WITH YOUR HOME. Yep – without regard to any rules listed elsewhere in Code Sections 1 through 1400 H (that's what “this chapter” contains!) we may not claim any deductions for the place where we live. If you live there, **KEEP IT OFF** of your tax return! Period.

2) THEN – EXCEPTIONS – The very next sentence in the Code deals with exceptions:

(b) Exception for interest, taxes, casualty losses, etc.

Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).

NOT BUSINESS OR INVESTMENT? OK – CLAIM YOUR DEDUCTIONS.

Since interest, taxes, and casualties are allowed without any question as to their connection with a trade or business, they're deductible. Effectively, these two sentences warn us not to claim *personal* deductions for the home

as if they were *business* deductions by claiming the expense has some *connection* with our trade, business, or investment activity.

IN A NUTSHELL: The effective meaning here is:

Expenses with regard to your home may *never* be connected with your business unless specifically allowed in this Code Section – with the exception of “interest, taxes, casualty, losses, etc.”. (That “etc.” leaves room for other deductions to be added by the Code – currently there are none.)

ANSWERS: I WANT TO DEDUCT - - -

1. HIGH ELECTRIC BILLS. I run a furnace in my garage to produce special metal alloys for my machine shop. This furnace accounts for nearly 80% of my electric bill. I want to deduct this on my tax return.

No. Unless the rules for a home office are met, you may not claim ANY costs connected with your home because of a business connection.

POSSIBLE EXCEPTION. The deduction would likely be allowed if the home had a COMPLETELY SEPARATE system of electric wiring, WITH ITS OWN METER. This is parallel to the idea of a completely separate telephone line into the home.

2. SECURITY SYSTEM. I keep sensitive computer backup data and records for my financial planning business in my home. Because of this, I have installed an expensive security system, and want to deduct part of the cost.

No. Unless the system is connected ONLY to the business items we have another “cost of the home” here. It is not covered by an exception, thus it is not deductible under Section 280A, unless the tests for the home office are met.

3. STORAGE. I’m a tax practitioner. I maintain a commercial office, but it’s small. I store most of my supplies and old tax returns at home. I want to deduct part of the costs of my home.

No. There is an exception for storage to be mentioned later, but we will see that it applies only to sellers of merchandise. Unless the tests for a home office are met, no deduction is allowed.

4. MY FILE CABINET. I do some work at home, and purchased a file cabinet to store the paperwork. The cabinet is in my den. May I deduct its cost?

Yes. True, the file cabinet is inside the home. However, it is not really a *part* of the home. It is *portable personal property* of the business. Claim the same deduction as if the file cabinet were at the place of business.

5. INTEREST AND TAXES. I devote about 10% of my home to my business. I don’t meet the “home office” rules, but since I cannot use this 10% for living purposes, I want to deduct 10% of my interest and taxes on my Schedule C.

Yes!!! The exception at 280(b) says precisely this. In fact, a counselor who maintained an office in the home, but could NOT claim a home office under Sec. 280A because of another commercial office, got exactly this answer with regard to mortgage interest from the Tax Court. *Hairston, Wayne (1995) TC Memo 1995-566, affd without op (1997, CA11) 116 F3d 492.*

NOTE: We could *not* have used this approach in Questions 1 or 2 – electric bills and security systems used at home are not “allowable without regard to his trade or business”.



BRIGHT IDEA –

COLLEGE PROFESSORS, ENGINEERS, LECTURERS. We all meet a few clients who have SE income but cannot qualify for a home office (either because they mix nonqualified usage in the space or cannot pass the exclusive use test).

INTEREST & TAXES – DIRECTLY ON SCHEDULE C. This exception allows these folks to directly enter the allocable share of interest and taxes on their Schedule C. Don't use Form 8829 at all! Picture \$10,000 in interest and taxes, with one room of 7 as an office. No home office allowed, but call the space 50% for self-employment, 50% as employee. That's about a 7%, or \$700 deduction on Schedule C – SE Tax just declined by \$100! Keep good notes, as you might be asked to justify your stance at audit!

NOTICE WHAT'S BEING SAID. We're all familiar with the “home office” concept. We normally seek to deduct parts of the costs of running the home. Review the chart below – it discusses what Code Section 280A *really* says!

Components of “Home Office” Deductions	
Mortgage Interest Property Tax Casualty Losses	Allowed by other Code Sections. These MAY BE CLAIMED for “trade or business use” which meets normal tests for reasonableness and “all facts and circumstances”. NO FORM 8829! In such cases no Form is provided. You'll need to do a side calculation and enter the result directly to Schedule C. (Be sure to keep good notes!)
Insurance, Utility Bills Maintenance Costs Rent (for rented property) Depreciation	Allowed ONLY if “business use” tests of Section 280A are met!

WHO MAY CLAIM A HOME OFFICE?

QUESTIONS: CAN I CLAIM A HOME OFFICE?

I'm a tax practitioner.

1. **DEDICATED SPACE.** I maintain a commercial office, but do much of my actual processing of returns from a dedicated office space in my home.

2. **I WORK AT HOME.** I work from my home. I meet my clients there, or at the clients' homes. I have no other office.

3. **A FEW CLIENTS AT HOME.** I do most of my work from a commercial office, but take a couple of days each month to meet with clients in an office at my home. This location is much more convenient for these particular clients.

4. **STORAGE.** I maintain a commercial office, but it's small. I store most of my supplies and old tax returns at home and do much of my computer work there.

5. **GARAGE OFFICE.** Most of my work is done in the downtown office, but I've converted our detached garage at home into an office, and do a fair amount of my work there.

6. **I MAKE HOUSE CALLS.** I meet all my clients in their homes, and do all my office work from an office space in my home.

7. **SIDE BUSINESS.** My tax office is in a shopping center. Outside the tax season I run a small business as a chimney cleaner. My tools are kept at home, and I have a small office there to take care of ordering parts and doing bookwork for this side business.

8. **EMPLOYEE.** I'm employed by a small tax firm and work at their offices. I take lots of work home and maintain a dedicated office there.

ANALYSIS AND ANSWERS

QUALIFYING BUSINESS USE is dealt with in §280A(c).

"(c) Exceptions for certain business or rental use; limitation on deductions for such use.

(1) Certain business use.

Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis --

(A) as the principal place of business for any trade or business of the taxpayer,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer.

"For purposes of subparagraph (A), the term "principal place of business" includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business."

Let's look at some of the underlined terms:

"ALLOCABLE TO" is very important. We'll return to this subject later.

"REGULAR AND EXCLUSIVE" has always been interpreted STRICTLY by the courts. Every use of the space must be qualifying use. This is a FIRST requirement – *in addition*, you must meet at least one of the following tests:

PRINCIPAL PLACE OF BUSINESS gave rise to several years of argument after the Soliman case, and ultimately led to the new law in the last paragraph above.

"USED BY CLIENTS" is separate from the "principal place of business" test.

Though a business operates from commercial space it is possible to have a home office if you meet clients at home on a "regular and exclusive" basis.

SEPARATE STRUCTURE. A controlling phrase here has become "appurtenant to". Courts have ruled a building "appurtenant" to another when they were connected by a walkway! The only absolutely safe test of "separateness" is whether the structures could be conveyed separately under local law.

FOR THE CONVENIENCE OF EMPLOYER is an *additional test* for employees - it essentially means REQUIRED by employer. The wording allows IRS to ask whether the requirement can be shown to affect employer's needs and goals.

SPECIAL EXCEPTIONS: We know daycare providers need not have exclusive use, but they use a 2-step allocation formula. The other exception:

(2) Certain storage use.

Subsection (a) shall not apply to any item to the extent such item is allocable to space within the dwelling unit which is used on a regular basis as a storage unit for the inventory or product samples of the taxpayer held for use in the taxpayer's trade or business of selling products at retail or wholesale, but only if the dwelling unit is the sole fixed location of such trade or business.

PUTTING IT ALL TOGETHER: Thus, qualifying for the deduction involves several steps. Here they are in a simple chart:

Home Office Deductions – Who Qualifies?		
1) Character Of Space		
<p>Used Regularly and Exclusively for business. Need not be a separate room. Usage may not be mixed with any non-qualified usage. No exceptions, except "time and use" tests for day care centers.</p>		
2) Business Use - Meet any ONE of the tests below:		
<p>Principal Place</p> <p>Administrative or management activity at home PLUS NO OTHER FIXED LOCATION where significant amounts of such work is done.</p>	<p>Meet Clients</p> <p>Meet clients, patients, or customers on a regular basis.</p>	<p>Separate Structure</p> <p>Beware of your state's definition of "appurtenant".</p>
3) Employees Only		
<p>Additional test – Required by employer as a condition of employment – no exceptions.</p>		
4) Storage Exception.		
<p>Sellers only (wholesale or retail) – space used for storage of inventory and/or product samples (Do NOT include storage of supplies, records, etc.). Home must be only fixed location of the business.</p>		

BACK TO THE QUESTIONS! Now let us apply this knowledge to the questions from page 5.

ANSWERS: CAN I CLAIM A HOME OFFICE?

I'm a tax practitioner.

1. **DEDICATED SPACE.** I maintain a commercial office, but do much of my actual processing of returns from a dedicated office space in my home.

No. While administrative or managerial tasks are performed in the home office, it is NOT true that there is no other site where significant amounts of such work are done. (Unless the work done in the commercial office is insignificant!)

TIP: Consider whether interest and taxes are allowed on Schedule C!

2. **I WORK AT HOME.** I work from my home. I meet my clients there, or at the clients' homes. I have no other office.

Yes. Once the clients enter the space we meet the second test – (1)(B). There is no issue over where “principal place” of business lies. Assuming we meet the “exclusive” part of the test, claim the deductions.

3. **A FEW CLIENTS AT HOME.** I do most of my work from a commercial office, but take a couple of days each month to meet with clients in an office at my home. This location is much more convenient for these particular clients.

Yes. Clearly the “principal” place of business is at the commercial office. However, the regular usage of the home space by clients opens the door to this deduction. Test (1)(B) again!

4. **STORAGE.** I maintain a commercial office, but it's small. I store most of my supplies and old tax returns at home and do much of my computer work there.

No. The exception for storage does not apply. Taxpayer is not in a “trade or business of selling products at retail or wholesale”. Nor will taxpayer qualify because of the computer work, as there is another location where such work may be performed.

TIP: Consider whether interest and taxes are allowed on Schedule C!

5. **GARAGE OFFICE.** Most of my work is done in the downtown office, but I've converted our detached garage at home into an office, and do a fair amount of my work there.

Possible, but not guaranteed. The “separate structure” criterion would seem to apply, but a review of Court cases casts some doubt. In one case, the deduction was disallowed because the “separate structure” was connected to the home by a walkway. In another case, the Court asked whether the structure could be “conveyed separately” (which is – could you sell the garage without selling the home?).

6. I MAKE HOUSE CALLS. I meet all my clients in their homes, and do all my office work from an office space in my home.

Yes – clearly. The work at the home office is significant, and there is no other location where taxpayer may perform this work. As long as you can pass the “exclusive use” test, claim the home office deduction.

7. SIDE BUSINESS. My tax office is in a shopping center. Outside the tax season I run a small business as a chimney cleaner. My tools are kept at home, and I have a small office there to take care of ordering parts and doing bookwork for this side business.

This is another clear case of YES. Just be sure none of the tax work is done in this space. The space qualifies, but ONLY for the chimney cleaning business.

8. EMPLOYEE. I’m employed by a small tax firm and work at their offices. I take lots of work home and maintain a dedicated office there.

Not likely. We have an employee. Regardless the amount of work performed at home, we need “for employer’s convenience”. This demands not only a requirement by employer, but the requirement must be sensible.

CLAIMING THE DEDUCTION

FORM 8829? OR A SEPARATE WORKSHEET? IRS instructions say the Form 8829 is used only by certain filers.

USE THE FORM if you are:

- Self Employed (unless the expenses are properly allocable to inventory), or
- Home-Based Daycare Provider

USE A SEPARATE WORKSHEET (and there is one provided near the end of Publication 587, although the steps are identical to those on the Form 8829), if you are claiming your deductions as

- **AN EMPLOYEE.** All deductions for the home office, except those for interest, taxes, and casualty are claimed on Schedule A Miscellany, subject to the 2% of AGI floor.
- **PARTNERS** use the worksheet and transfer the costs to Schedule E.
- **SCHEDULE F FILERS** use the worksheet and carry the expenses to the appropriate part of Schedule F.
- **STATUTORY EMPLOYEES** use the worksheet and carry the expense to Schedule C.

WARNING!
 Not everyone claiming a home office
 uses Form 8829 – see prior page.

Form **8829**

Expenses for Business Use of Your Home

OMB No. 1545-0074

2012

Department of the Treasury
 Internal Revenue Service (99)

File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.
 Information about Form 8829 and its separate instructions is at www.irs.gov/form8829

Attachment
 Sequence No. **176**

Name(s) of proprietor(s)

Your social security number

Part I Part of Your Home Used for Business

1 Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions).....	1	
2 Total area of home.....	2	
3 Divide line 1 by line 2. Enter the result as a percentage.....	3	%
For daycare facilities not used exclusively for business go to line 4. All others go to line 7.		
4 Multiply days used for daycare during year by hours used per day.....	4	hr
5 Total hours available for use during the year (366 days x 24 hours) (see instructions).....	5	hr
6 Divide line 4 by line 5. Enter the result as a decimal amount.....	6	
7 Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3.....	7	%

Part II Figure Your Allowable Deduction

8 Enter the amount from Schedule C, line 29, plus any gain derived from the business use of your home and shown on Schedule D or Form 4797, minus any loss from the trade or business not derived from the business use of your home and shown on Schedule D or Form 4797. See instructions.....	8	
<i>See instrs for columns (a) and (b) before completing lines 9-21.</i>		
	(a) Direct expenses	(b) Indirect expenses
9 Casualty losses (see instructions).....	9	
10 Deductible mortgage interest (see instructions).....	10	
11 Real estate taxes (see instructions).....	11	
12 Add lines 9, 10, and 11.....	12	
13 Multiply line 12, column (b) by line 7.....	13	
14 Add line 12, column (a) and line 13.....	14	
15 Subtract line 14 from line 8. If zero or less, enter -0.....	15	
16 Excess mortgage interest (see instructions).....	16	
17 Insurance.....	17	
18 Rent.....	18	
19 Repairs and maintenance.....	19	
20 Utilities.....	20	
21 Other expenses (see instrs).....	21	
22 Add lines 16 through 21.....	22	
23 Multiply line 22, column (b) by line 7.....	23	
24 Carryover of operating expenses from 2011 Form 8829, line 42.....	24	
25 Add line 22 column (a), line 23, and line 24.....	25	
26 Allowable operating expenses. Enter the smaller of line 15 or line 25.....	26	
27 Limit on excess casualty losses and depreciation. Subtract line 26 from line 15.....	27	
28 Excess casualty losses (see instructions).....	28	
29 Depreciation of your home from line 41 below.....	29	
30 Carryover of excess casualty losses and depreciation from 2011 Form 8829, line 43.....	30	
31 Add lines 28 through 30.....	31	
32 Allowable excess casualty losses and depreciation. Enter the smaller of line 27 or line 31.....	32	
33 Add lines 14, 26, and 32.....	33	
34 Casualty loss portion, if any, from lines 14 and 32. Carry amount to Form 4684 (see instructions).....	34	
35 Allowable expenses for business use of your home. Subtract line 34 from line 33. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions.....	35	

Part III Depreciation of Your Home

36 Enter the smaller of your home's adjusted basis or its fair market value (see instructions).....	36	
37 Value of land included on line 36.....	37	
38 Basis of building. Subtract line 37 from line 36.....	38	
39 Business basis of building. Multiply line 38 by line 7.....	39	
40 Depreciation percentage (see instructions).....	40	%
41 Depreciation allowable (see instructions). Multiply line 39 by line 40. Enter here and on line 29 above.....	41	

Part IV Carryover of Unallowed Expenses to 2013

42 Operating expenses. Subtract line 26 from line 25. If less than zero, enter -0.....	42	
43 Excess casualty losses and depreciation. Subtract line 32 from line 31. If less than zero, enter -0.....	43	

BAA For Paperwork Reduction Act Notice, see your tax return instructions.

FDIA6902L 08/16/12

Form 8829 (2012)

**FORM 8829 – LINES 1-7
WHAT PART OF THE HOME?**

QUESTIONS – WHAT PART OF HOME:

1. SPACE ALLOCATION T/P runs a business from home. T/P uses a 150 square foot room out of a 1500 square foot home, plus uses one-half of a 500 square foot garage for storage. (Property tax bill shows \$200,000 allocable to improvements.) What's a reasonable allocation?

2. SMALL ROOM – IS IT WORTH THE TROUBLE? T/P runs a business from home. T/P uses the smallest of 3 bedrooms as an office. It seems unlikely the allocation will be even 10% of the home's space. Is it worth bothering with the deduction?

3. DAYCARE ALLOCATIONS. T/P runs a home daycare operation for 9 hours on weekdays using most of the home occasionally (but not husband's den!!), but only a single closet for storage of toys on an exclusive basis. How is the allocation calculated on the form?

ANALYSIS AND ANSWERS

ALLOCATION – ROOMS VS. SQUARE FEET. Regulations (as well as Form 8829 instructions) allow any reasonable and consistent method. Consider checking both square footage and room-count, using the most advantageous. How to count rooms? IRS suggests the method works only if the rooms are of approximately the same size. However, a review of Court cases shows large variation – this suggests the issue is a matter of “all facts and circumstances.”

**COURT CASES – HOW MANY ROOMS?**

5.5 ROOMS. In one case, the Court allowed 1.0 of 5.5 rooms. The rooms were two bedrooms, living room, dining room, den and “half” kitchen. Interestingly, the bathroom, garage, and any storage, crawl, or basement space were **IGNORED!**

DON'T COUNT BATHROOMS OR GARAGE. Following this case would lead to this conclusion. A typical 3-bedroom home has 5, 6, or 7 rooms (3 for bedrooms. Either 2 or 3 for living room, dining room, and kitchen. Perhaps an extra room for den or family room.)

Moretti, Gene (1982) TC Memo 1982-552.

ROOMS WON'T WORK. In another case, taxpayer was not allowed one room of eight (12.5%), but only 5% per the actual square footage, because the rooms in question were not the same size or even approximately the same size.

Andrews, Edward (1990) TC Memo 1990-391, vacd & remd on another issue (1991, CA1)

WHO CARES ABOUT SIZE? We find a case where T/P used one of six rooms as his office (giving 1/6 or 16.67%), even though the room accounted for only 100 sq. ft. of a home measuring 1800 sq. ft.!

Swain, Abhimanyu, (1996) TC Memo 1996-22, affd without op (1996, CA4) 78AFTR 2d 96-6552.

EVEN PARTIAL ROOMS CAN BE USED.**COURT CASE – PART OF A ROOM?**

PIANO TEACHER. The law only requires that a space be used “regularly and exclusively” when we seek home office deductions.

There is no requirement that the “space” be a “room” with separate walls, etc.. The Tax Court upheld this position in the case of a piano teacher whose piano was in a large living room. She contended the portion of the room containing the piano was used solely for her teaching activities. Her logs and photographs bore out her claim, and the Court agreed.

Hewett, TC Memo 96-110.

BEWARE OF NON-QUALIFYING USE. Regulations allow for use of the same space for multiple *qualifying* business activities, but warn that *non-qualified* use will break the “exclusive use” rule.



COURT CASE

ALL USE MUST QUALIFY or no deduction. In the case, T/P used his home office as the site from which to run a side business. Since he used the same space for some of his employee duties (a non-qualifying use), he was not allowed to claim the home office on his Schedule C. Whew! (*Alfred Hamacher, 94 TC No. 21*)

OFFICE USED BY BOTH SPOUSES. Occasionally a space is used by both spouses. What happens if one spouse’s use qualifies for deduction, but the other’s does not?



COURT CASE - SHARED OFFICE

Both spouses used a room in the house. It had two desks, two chairs, bookshelves, etc. Spouse’s usage qualified under §280A as a home office. Taxpayer’s use did not.

ALLOWED IN FULL. The Court allowed spouse to deduct the cost of the full office. No allocation was required.

WARNING. This case is unusual, and IRS might be expected to challenge a similar case in the future.

Frankel, Max (1984) 82 TC 318.

DAYCARE – DOUBLE CALCULATION. IRC 280A(c)(4) gives a 2-step process:

1. Room Usage. First calculate the fraction of the home for all rooms regularly used for the daycare business, (Lines 1-3 of Form 8829)
2. Hours of operation. Then multiply this percentage by the portion of the year (8,760 hours) the facility is used for daycare. (Lines 4-6 of Form 8829)

BACK TO THE QUESTIONS.**QUESTIONS – WHAT PART OF HOME:**

1. SPACE ALLOCATION T/P runs a business from home. T/P uses a 150 square foot room out of a 1500 square foot home, plus uses one-half of a 500 square foot garage for storage. (Property tax bill shows \$200,000 allocable to improvements.) What's a reasonable allocation?

COSTS OF CONSTRUCTION?? We have a 150 sq. ft. room, plus 250 sq. ft. for half the garage, a total of 400 sq. ft.. If you compare 400 total sq ft to 2000 sq ft you get 20% of \$200,000, or \$40,000 as basis of the "office". HOWEVER, most appraisers will say garages cost about 50% as much to build as the rest of a typical home. They'd equate the 500 sq ft garage to 250 sq ft of finished residence - now the "structure" contains 1750 sq ft. 150 sq ft is the original office, and another 125 sq ft is the "construction equivalent" of the half of the garage used for storage. Now the basis of the "office" is $275/1750$ (about 15.7%) X \$200,000 = \$31,428. Several approaches are defensible! The point is that IRS has never approached this problem – work for your client's best interest!

2. SMALL ROOM – IS IT WORTH THE TROUBLE? T/P runs a business from home. T/P uses the smallest of 3 bedrooms as an office. It seems unlikely the allocation will be even 10% of the home's space. Is it worth bothering with the deduction?

USE ROOM COUNTS. Following the Andrews case mentioned earlier we'd usually get either 1/5, 1/6, or 1/7 as the business portion for a 3-BR home.

SOFTWARE NOTE: Most software simply follows the IRS Form, thus allowing only input for square footage. In the above case, suppose the home is 1400 square feet. If using room count leads to any of 1/5, 1/6, or 1/7 of the home, then simply enter the "square footage" of the room in question as 280, 233, or 200 respectively, regardless the actual size of the room.

3. DAYCARE ALLOCATIONS. T/P runs a home daycare operation for 9 hours on weekdays using most of the home occasionally (but not husband's den!!), but only a single closet for storage of toys on an exclusive basis. How is the allocation calculated on the form?

DOUBLE CALCULATION. Step 1 - Suppose that by leaving out husband's den we have 85% of the home in use for day care. Step 2 - The hours of operation – 5 days X 9 hours X 50 weeks = 2,250 hours. $2,250 \text{ hours} / 8760 \text{ hours} = 25.7\%$. Finally multiply the 85% by the 25.7% to get 21.8%.

TIP: Though IRS stops here, we recommend asking client about time spent on cleaning and maintenance for the daycare operation. If this adds 2½ hours per week, the usage percent goes from 25.7% to 27.1%.

**FORM 8829 – LINES 8-15
CASUALTIES, INTEREST, TAXES**

QUESTIONS: - INTEREST DEDUCTIONS

In all questions below T/P has a qualifying home office with business percent of 20%. Discuss the treatment of the interest on the debt in question.

1. T/P paid \$10,000 interest on his mortgage. The original \$150,000 loan was refinanced to \$200,000 two years ago - the extra \$50,000 was used to clear up consumer debt.

2. T/P spent \$10,000 to renovate the home office itself. The expenses were charged to a credit card. This year the interest is \$1,500.

3. T/P bought the home just two years ago, and the mortgage is \$1,500,000 - interest this year is \$60,000.

4. T/P paid \$6,000 interest on the first mortgage to buy the home. T/P also paid \$2,000 on an equity line of credit to purchase office equipment and computers for the business.

5. T/P has 3 homes. Home 1 and 2 are used for deductions on Schedule A. Home 3 is used 20% for business. T/P paid \$8,000 interest on home 3.

6. T/P is a tax consultant with clients in San Diego and Palm Springs. He has home offices in both cities and pays \$10,000 interest on each mortgage.

ANALYSIS AND ANSWERS

"ALLOCABLE" The Code does not define "allocable" – but several court cases indicate the term means more than simple arithmetic. There must be a logical, *bonafide* relationship in the usage.

"FOR THE BENEFIT OF" IRS uses this phrase instead of the word "allocable" in the form instructions.

RELATED TO THE BUSINESS USE would seem to be a similar idea. That an expense "belongs" to the home is not sufficient - it should be specifically and logically related to the business usage.

LINE 10 AND LINE 16 of Form 8829 are BOTH used to report interest (see Form on Page 12) – their difference is important. Note what the Form instructions say about these lines:

ON LINE 10, include only mortgage interest that would be deductible on Schedule A and that qualifies as a direct or indirect expense. Do not include interest on a mortgage loan that did not benefit the home (e.g., home equity loan used to pay off credit card bills, to buy a car, or to pay tuition costs).

LINE 16.— If the amount of home mortgage interest you deduct on Schedule A is limited, enter the part of the excess mortgage interest that qualifies as a direct or indirect expense. Do not include mortgage interest on a loan that did not benefit your home (explained above).

There are two key differences between the lines:

1. **"ALLOWABLE ON SCHEDULE A"** is the first difference. Line 10 is for items which would be deductible on Schedule A. Mortgage interest you can not otherwise deduct on Schedule A belongs on Line 16.
2. **SUBJECT TO GROSS INCOME LIMITATION.** The items on Line 10 are NOT subject to the limitation - they are deductible even if there is a net business loss. The items on Line 16 ARE subject to the income limitation – you might have to carry them forward.

**TAX TRAP!!! ALTERNATIVE MINIMUM TAX**

ONLY PURCHASE MONEY INTEREST DEDUCTIBLE! Don't forget, AMT applies to ALL interest that is not paid on loans to buy, build, or improve the home. This trap is not specifically related to the home office, but cannot be forgotten.

"FOR THE BENEFIT OF" is an appropriate phrase when thinking of the AMT – interest on any loan which is not "for the benefit of" the home is a tax preference when calculating the AMT.

CASUALTY LOSSES. IRS instructions say: Treat casualty losses as personal expenses for this step. Figure the amount to enter on line 9 by completing Form 4684, Section A. When figuring Form 4684, line 17, enter 10% of your adjusted gross income excluding the gross income from business use of your home and the deductions attributable to that income. Include on Form 8829, line 9, the amount from Form 4684, line 21. See *Line 27* below to deduct part of the casualty losses not allowed because of the limits on Form 4684.

Do not file or use that Form 4684 to figure the amount of casualty losses to deduct on Schedule A. Instead, complete a separate Form 4684 to deduct the personal portion of your casualty losses.

The end result of this is to claim the business fraction of a slightly different casualty loss than would normally appear on Schedule A. The 10% of AGI floor is calculated without reference to the business. Finally, the casualty is recalculated in normal fashion, and the non-business portion will go to Schedule A.

PROPERTY TAXES are handled in similar fashion. Note that taxes not attributable to the home in general (e.g., an additional assessment for an easement) should be ignored.



FORMS NOTE UNDERSTANDING FORM 8829

LINES 8-14 – NOT RELATED TO §280A! The lines used to calculate the allowable portion of mortgage interest, taxes, and certain casualties do not come from IRC Section 280A. Section 280A(1)(b) specifically EXCEPTS these items from governance by this section.

NO LIMITS will be placed on these deductions. They may be claimed even if the result is a net loss for the business activity.

THIS EXCEPTION is dealt with on lines 9, 10, and 11 of Form 8829. Note that any deduction claimed on these lines is summarized at line 14 and will be allowed even if the rest of the expenses are limited - a net loss on Schedule C can result from entries here.

LINE 15 – SCHEDULE C NET INCOME AFTER INTEREST AND TAXES. The form then continues with the items which ARE governed by §280A.

DIFFERENT USAGE PERCENT??? In fact, it is possible that some taxpayers use a larger portion of the home partly for business, but cannot meet the “regular and exclusive” requirement for the extra portion. Would they not be allowed to use the precepts of §162 to determine a reasonable percentage for interest and taxes, then proceed with the §280A limitations for the portion of the home which DOES meet the “regular and exclusive” tests? **FORMS NOTE:** In such cases we have no guidance – perhaps a side calculation with additional entries in the “Direct” area, or even a direct entry onto Schedule C.

ANSWERS: - INTEREST DEDUCTIONS

In all questions below T/P has a qualifying home office with business percent of 20%. Discuss the treatment of the interest on the debt in question.

1. T/P paid \$10,000 interest on his mortgage. The original \$150,000 loan was refinanced to \$200,000 two years ago - the extra \$50,000 was used to clear up consumer debt.

Interest on \$150,000 (approx. \$7,500) goes to Line 10 as an indirect expense. Interest on the balance (approx. \$2,500 interest on \$50,000 debt) goes to Schedule A only (and should appear as an AMT adjustment!).

2. T/P spent \$10,000 to renovate the home office itself. The expenses were charged to a credit card. This year the interest is \$1,500.

The interest is a direct expense on Line 16 (nothing is allowed on Schedule A - the loan is not secured by the home, it's not "qualified residence interest").

3. T/P bought the home just two years ago, and the mortgage is \$1,500,000 - interest this year is \$60,000.

Interest on up to \$1,100,000 is allowable on Schedule A, thus \$44,000 interest is an indirect expense on Line 10. The other \$16,000 of interest is NOT deductible on Schedule A, but IS an indirect expense on Line 16.

4. T/P paid \$6,000 interest on the first mortgage to buy the home. T/P also paid \$2,000 on an equity line of credit to purchase office equipment and computers for the business.

The \$6,000 interest is an indirect expense on Line 10 of Form 8829. The \$2,000 is completely deductible on Schedule C (do not use Form 8829!).

5. T/P has 3 homes. Home 1 and 2 are used for deductions on Schedule A. Home 3 is used 20% for the business. T/P paid \$8,000 interest on home 3.

None of Home #3's interest is deductible on Schedule A, but 20% of the \$8,000 interest is allowable as a Home Office deduction - use Line 16 of Form 8829.

6. T/P is a tax consultant with clients in San Diego and Palm Springs. He has home offices in both cities and pays \$10,000 interest on each mortgage.

Two possibilities here. If he does not meet clients in the offices, for the home which is PRINCIPAL place of business, the interest is an indirect expense on Line 16, and the other home's mortgage is deductible on Schedule A only. If he does meet clients, there's no rule against having two offices, but you'll need to use two different Forms 8829 to do the reporting.

**FORM 8829 – LINES 16-35
OPERATING EXPENSES**

QUESTIONS: - OPERATING EXPENSES

Which of the following would qualify as “operating costs” on Lines 17–20 of Form 8829?

Homeowner’s Insurance

Security system and monitoring

Water bills

Electric bills

Trash collection

House cleaning costs

Household maintenance supplies – solutions, waxes, trash bags, etc.

Roof repair

Pool service

Gardening and landscaping

Lawn maintenance

Condominium Association dues

Water purifier system

Fire wood

Window repair

Cable TV

Anything else you can think of

ANALYSIS AND ANSWERS

"ALLOCABLE" The Code does not define "allocable" - but several court cases indicate the term means more than simple arithmetic. There must be a logical, bonafide relationship in the usage.

"FOR THE BENEFIT OF" IRS uses this phrase instead of the word "allocable" in the form instructions.

DIRECT VS. INDIRECT. Once an expense is determined to be allocable to business usage we need one more step. Does the expense stem directly from the business usage? Or is the expense a general one for the home in its entirety? If the expense arises specifically from the business use, it's a direct expense (no allocation needed.). Note the columns on the Form (Page 12).

LANDSCAPING EXPENSES. IRS used to say landscaping expenses benefit only the part of the home NOT used as an office. But the Tax Court has disagreed, and IRS has withdrawn its comments.

HOME TELEPHONE EXPENSE. The cost of the first telephone line into the home (providing Basic telephone service) is not allowed as a business expense. (*IRC §262(b)*). However, the cost of toll calls for business from this same telephone are always deductible – claim this on Schedule C, not Form 8829. (*IRS Publication 587, Page 9*).

OUR QUESTIONS – ONLY POOL SERVICE AND CABLE TV ARE

DOUBTFUL. Although IRS auditors might have additional objections, we suggest all the other are includible. In fact, the pool service is included by most practitioners on the grounds that without such services the environment could become unsafe due to the breeding of algae, mosquitoes, and several unnamed forms of bacteria. And frankly, Cable TV is probably a "utility" in modern America – when's the last time you saw a TV antenna??!!

CONDO ASSOCIATION DUES are a great example. Auditors generally allow these as part of a home's cost. However, these dues pay for a multitude of services, often including:

- Pool maintenance
- Recreation room facilities
- Cable TV
- Landscaping
- Lawn service
- Fire insurance
- Water bills
- Capital reserves for anticipated replacements
- And more

**FORM 8829 – LINES 36-41
BASIS AND DEPRECIATION**

QUESTIONS – BASIS ISSUES:

IMPROVEMENTS. Taxpayer runs a small consulting business from home. Business percent has always been 15% for Form 8829. How much do the following improvements add to the home office basis?

- a) T/P spends \$25,000 to add a swimming pool.
- b) T/P spends \$50,000 to add a master bedroom.
- c) T/P spends \$10,000 to carpet all the home, EXCEPT the office space.
- d) T/P spends \$15,000 to add wiring, telephone lines, a separate entrance, and air conditioning to the office space alone.

QUESTIONS A, B, AND C – “ALLOCABLE TO”???? Looked at in isolation, each item appears to have no bearing on the home office space.

- a) The swimming pool clearly has no relation to the “inner space” of the home.
- b) The master bedroom is clearly unrelated to the office, but is definitely a part of the home. However, the business percent is now different since the home is larger – perhaps the new percent is not 15% but 12%.
- c) None of the carpeting benefits the office space.

OUR ANSWER – ALL ADD TO BASIS!! To understand our position, try this: The home is sold immediately after all improvements are completed. The buyer runs a home-based business with home office and comes to you for tax assistance.

NOW IT'S EASY! Simply a new client with an expensive home, a home office occupying 12% of the property, and a basis which clearly includes all costs.

QUESTION D – DIRECT EXPENSE- OR IS IT?? This question is tricky. All the costs directly relate to the office. But - - - -

NO “DIRECT” AND “INDIRECT” COLUMNS. The form has no easy way to apply different “usage” percentages to depreciable items. Instructions say to include a statement detailing our calculations. But we use software - - -

SOFTWARE NOTE. Your software is probably not capable of dealing with this. Perhaps a “side calculation” of this depreciation, then include the amount as a direct expense among the “other” operating expenses on Line 21.

DIRECT TO SCHEDULE C – NO!!! This expense is still a part of the home, and must be subjected to the gross income tests for the business. Entering this directly onto Schedule C would bypass the limitation.

SECTION 1250 UNRECAPTURED GAIN. When the home sells, any gain attributable to this depreciation may not be excluded under Section 121. Somehow, we must track this depreciation.

EMPLOYEE VS. SCHEDULE C

DIFFERENT TREATMENT FOR COMPONENTS OF DEDUCTION. Employees and self-employed folks have entirely different values (and motivation!!) for the home office deduction. The table below summarizes the differences.

Value of Home office Deductions Employee vs. Self-Employed		
Deduction Component	Employee	Self-Employed
Deduction in General	Must be able to itemize deductions on Schedule A.	Deductions go to Sched. C. AGI is lowered SE Tax is reduced. Helpful even if using Standard Deduction.
Interest, Property Tax, Casualty Loss	No difference – Deductions are all claimed as long as they exceed the Standard Deduction.	Moving these deductions to Sched. C lowers SE tax and might give benefit to using the Standard Deduction.
Insurance Maintenance, Utility bills	New deductions, but subject to 2% floor.	New deductions, normally not allowed – all claimed on Sched. C.
Rent	New Deduction, but subject to 2% floor..	Renters claim on Sched. C
Depreciation	Subject to 2% floor, plus treated as Section 1250 Unrecaptured Gain at sale.	Lowers SE Tax. Treated as Section 1250 Unrecaptured Gain at sale.

CLEARLY SELF-EMPLOYED FOLKS CAN DERIVE BIG BENEFITS from these deductions. Not only are they able to claim deductions for items normally not dealt with on a tax return, but they also lower both AGI and SE-taxable income in the process. The 2% floor is ont an issue for these folks.

EMPLOYEES DERIVE LESS BENEFIT from home office deductions. They must itemize deductions, beat the 2% floor, and not run into the AMT.

*ELECTION
Try due-date
of timely filed
return*

**NEW IRS "SAFE HARBOR"
CALCULATION**

REV. PROC 2013-13 gives a simplified calculation method for home office deductions. Only the calculation is affected.

\$5 PER SQ. FT. – MAX 300 SQ. FT. No record-keeping of separate utility bills, maintenance, association dues, etc.. A simple \$5 per square foot on up to 300 square feet of space.

NORMAL QUALIFYING RULES apply. A dedicated space, regular and exclusive use, etc. This "Safe Harbor" affects the

DETAILS. The rules in the Rev. Proc. include:

- \$5 per square foot, maximum deduction \$1,500 (\$5 rate to be adjusted as needed by IRS).
- Election by filing. Your choice is signaled by what is claimed on a *timely filed* return. No amendments to change method allowed.
- No additional actual expenses allowed.
- Not allowed for an employee who receives any advance, allowance, or reimbursement for such usage.
- Year-by-Year determination. Use the safe harbor this year, actual calculation in another year.
- Depreciation neither allowed nor "deemed" for any year the Safe Harbor method is used. Section 1250 unrecaptured gain is invoked only for years in which the "actual expenses method" is used.
- Carryovers from prior years are not allowed in any year the Safe Harbor is used.
- Partial year of usage, prorate by months, where 15 or more days of use within a month allows that month to be counted.
- Multiple business use - - - spouses or roommates, for example, each with qualifying business use, could each claim up to 300 square feet of usage.
- Multiple businesses of a single taxpayer can allocate the 300 square feet *among* the businesses.
- Multiple homes in the same year. May use Safe Harbor for at most one home.
- Income limitation. The deduction cannot exceed net business income. Any excess deduction is lost, *not* carried over.

OTHER NOTES:

DEPRECIATION TRACKING PROBLEMS. Since there is no deemed depreciation, we must learn to track the years – which used the Safe Harbor, and which used “actual expenses method”. This will be important when the home is sold. (Also a record-keeping problem if we don’t track the years!).

NEW CLIENTS. In a few years we’ll see this one: You take on a new client, and a look at last year’s return shows a Schedule C with home office. What happened in prior years? Safe Harbor? Full calculation on Form 8829?

METHOD OF CLAIM. Wait and see. IRS has yet to announce whether there will be a special form for the calculation.

IS THIS A GOOD DEAL? It certainly is simple. And, it avoids the Section 1250 Unrecaptured Gain issues upon sale of the home. However, it is not likely to give as large a deduction as the “actual expenses” method. We continue with a Comprehensive Example to compare the deductions using the safe harbor election with using Form 8829.

COMPREHENSIVE EXAMPLE

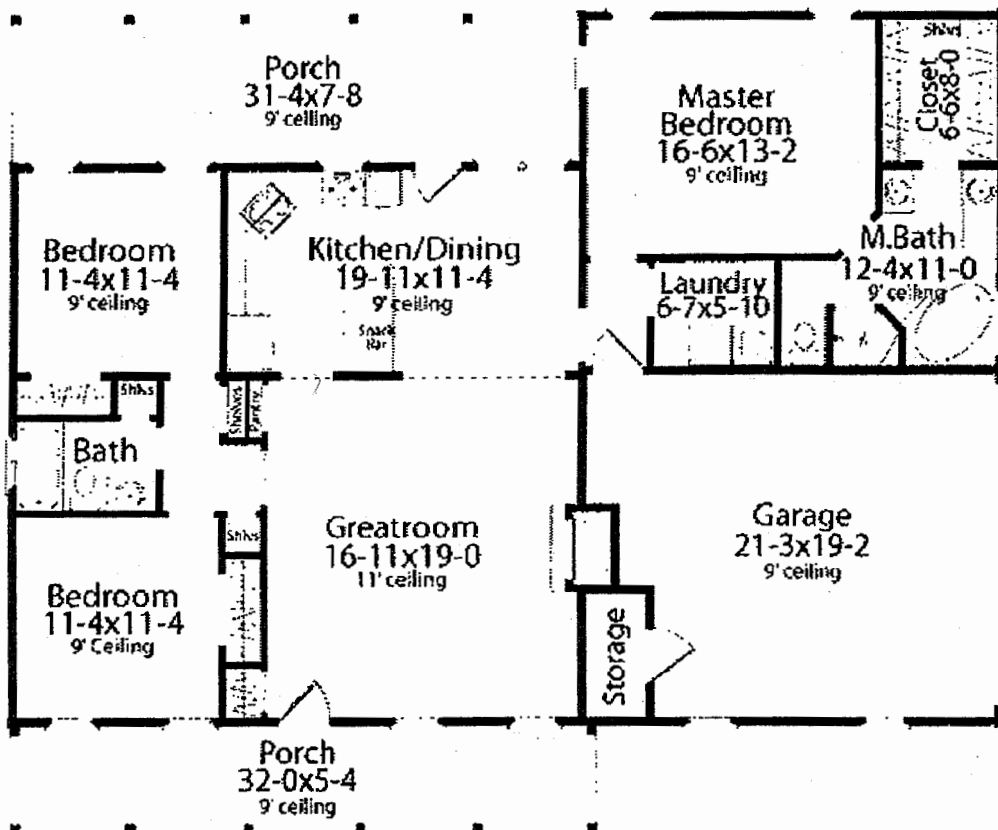
THREE-BEDROOM HOUSE. Below is the floor plan of a fairly ordinary home.

ONE OF THE LEFT-SIDE BEDROOMS IS AN OFFICE.

LET'S COMPARE METHODS. We'll look at "square feet method", "room-count" method, and the new "Safe Harbor" method.

DETAILS OF THE HOME: Rooms are marked for size. Other numbers:

- Total Area – 1492 sq. ft.
- Office Area – 128.4 sq. ft.
- Cost of Property - \$320,000. Allocated as \$125,000 for land, \$195,000 for the structure.
- Interest & taxes. Mortgage is \$250,000 @ 4% - \$10,000 interest per year, property tax is \$4,000 per year.



COMPARISON: The table below compares the results for the different methods, and for the Employee vs. the Schedule C filer.

Home Office Deduction Comparison			
Item/Meth	Square Feet	Room Count	Safe Harbor
Office Size	128.4 sq. ft.	1 Room	128.4 sq. ft.
Home Size	1492 sq. ft	5 rooms	N/A
Percent	8.61%	20%	N/A
Allowed only because of Home Office:			
Insurance - \$1,000	\$ 86	\$ 200	N/A
Utilities - \$2,000	\$172	\$ 400	N/A
Maint. - \$2,000	<u>\$172</u> \$430	<u>\$ 400</u> \$1,000	<u>N/A</u> \$ 642 (\$5 per sq. ft.)
Total	<u>\$ 43</u>	<u>\$ 100</u>	N/A
Depreciation	\$473 - "new" deductions	\$1,100 - "new" deduction	\$642 - "new" deductions
<p>NOTE: The deductions above are "new" deductions, only allowed because of the "business usage" of a part of the home.</p> <p>Depreciation allowed or allowable <i>might</i> become Section 1250 Unrecaptured Gain some day.</p>			
Interest \$10,000	\$861	\$2,000	Claim normally on Schedule A
Taxes \$ 4,000	\$344	\$ 800	
<p>NOTE: Interest & Taxes are always deductible, only the LOCATION of the deduction is affected. This depends upon type of "trade or business": Schedule C filers move these to Schedule C Employees leave these on Schedule A "Safe Harbor" users do nothing – all stays on Schedule A.</p>			
Deductions affecting SE Tax	\$1,678	\$3,900	\$ 642

NOTES & COMMENTS:

SINGLE EXAMPLE – MANY COMBINATIONS. Several floor plans might be considered. This one is "ordinary" enough for our discussion.

A RENTER in the same home might pay \$2,000 monthly. The same comparison would involve only the \$24,000 in rent, \$2,000 for utilities, plus a modest amount for maintenance and cleaning, say \$1,000. The parallel deductions would become:

\$2,325 \$5,400 \$ 642.

SQUARE FEET vs. ROOM COUNT. Many practitioners feel the “room count” method is too aggressive, yet Courts consistently uphold the method. How is our “20%” achieved on the Form? IRS says to use “any reasonable method”, yet the Form only mentions square feet. Improvise! Using actual size of the home we’d see 298.4 sq. ft. of the total 1,492 sq. ft. (many would “round” the numbers to 300 and 1,500). (See Example 2 on Page 16.) Try using the good ol’ “MICOR” method – “Make It Come Out Right”!!

TOO AGGRESSIVE? Many find the room count aggressive. Hallways, closets, storage spaces and bathrooms are totally ignored. But - - - what sort of “living” activities are performed in these spaces? The garage is also ignored, even though clearly a part of the “building”. (NOTE: Some businesses would use some, or all, of the garage for storage or workspace. In such cases, treat the two-car garage as a single room, since the space is far cheaper to construct. See Example 1, Page 16.)

“FAMILY IS DEPRIVED OF” = “REGULAR AND EXCLUSIVE USE”.

A good question to throw at the client who thinks he/she qualifies for a home office deduction – “Is your family completely *deprived* of the benefit of using this space for ordinary family living?” If the space offers *no benefits* when entertaining or simply living life, it likely meets the “regular and exclusive use” test.

DEPRECIATION & SECTION 1250 UNRECAPTURED GAIN. Many practitioners still fear this. Remember, for this to be a problem the home must be sold, and sold for a net amount exceeding adjusted basis. Imagine a Schedule C T/P who used 10 years of our most aggressive “room count” approach. Upon sale, he’d have claimed \$1,000 of depreciation. Suppose in all the years of claiming the deduction, TP was in the 15% bracket for Federal tax and 6% for California tax, but in the year of sale the brackets are 25% and 9.3%. TP now pays $25\% + 9.3\% = 34.3\%$ on this \$1,000. Savings over the prior years were only $15\% + 6\% = 21\%$. But, wait! SE Tax savings were at 14.1%. Total – 35.1% vs. 34.3%. What problem??

USE THE SAFE HARBOR? Schedule C filers probably will avoid the safe harbor (don’t forget – no carryover is allowed in a year of low income!) Employees, including telecommuters, might do well with the simplicity of the Safe Harbor.

AUDIT-RESISTANT? There is some speculation that IRS is less likely to question the Home Office these days. Work patterns have changed. Modern communications make it possible for more workers to accomplish their tasks from home. So - - - is IRS less likely to audit those who use the new Safe Harbor method? Wait and see!

FORM 8829 – LINES 41 & 42 CARRYOVERS

QUESTIONS – CARRYOVERS:

LOSS CARRYOVERS. T/P ran an insurance business from home in 2011 and 2012 and built up \$2,500 of excess home office expense, including \$1,000 of depreciation. How much of this may be used for 2013 in the following cases?

- a) T/P quit the insurance business and began to sell software from home in 2013 and made a \$25,000 profit.
- b) T/P moved the insurance business at the end of 2012 into rented space downtown and made a \$25,000 profit in 2013.
- c) T/P shut the insurance business down in 2012. In 2017 T/P once again starts an insurance business and makes \$25,000 in 2017.
- d) T/P shut the insurance business in 2010. In 2013 T/P sells the home. Must the \$1,000 of depreciation be taken into account in reducing basis?

ANALYSIS AND ANSWERS

LIMITED TO INCOME. IRC §280A(c)(6) indicates the home office deduction cannot exceed the gross income of the business. Regulations and the Courts have agreed “gross” refers to the business profit **AFTER** considering **BOTH** the operating costs **AND** the home office deduction itself.

THREE TIERS of deduction exist in the calculation. Take them in order.

TIER 1: INTEREST, TAXES, CASUALTY come first. These may even cause the business to produce a loss. This is §280A(1)(b) at work. These items are allowed without regard to the limitations otherwise imposed by §280A. (See Line 14 of Form 8829)

TIER 2: OPERATING COSTS. These are the familiar utilities, insurance, upkeep, etc. They are allowed only to the extent other deductions already taken still leave a net profit from the business. (Line 26)

TIER 3: DEPRECIATION. The deduction is allowed only if a profit remains. (Line 41)

CARRYOVERS ALLOCATED TO USAGE. The carryover of disallowed expenses seems to apply to the **BUSINESS**, not the **PROPERTY** – the Code

refers to "the excess from such use" in discussing the carryover. This gives interesting interpretations when the business moves or changes. Think about it.

Any amount not allowable as a deduction under this chapter by reason of the preceding sentence shall be taken into account as a deduction (allocable to such use) under this chapter for the succeeding taxable year. Any amount taken into account for any taxable year under the preceding sentence shall be subject to the limitation of the 1st sentence of this paragraph whether or not the dwelling unit is used as a residence during such taxable year.

BELONGS TO BUSINESS, NOT TO HOME! If this interpretation is correct, the carryover is a characteristic of the business, not of the home. Thus the home might even be sold, but the carryover still belongs to the taxpayer!

QUESTIONS – CARRYOVERS:

LOSS CARRYOVERS. T/P ran an insurance business from home in 2011 and 2012 and built up \$2,500 of excess home office expense, including \$1,000 of depreciation. How much of this may be used for 2013 in the following cases?

a) T/P quit the insurance business and began to sell software from home in 2013 and made a \$25,000 profit.

None. The carryover belongs to the INSURANCE business (as we read the Code - there are no regs, and we can find no court cases).

b) T/P moved the insurance business at the end of 2012 into rented space downtown and made a \$25,000 profit in 2013.

\$2,500 - now the insurance business has a profit. It does not matter that there is no home office. Picture the Schedule C here – it shows rent on a commercial space, but also has a Form 8829 which shows no current expenses, but does show a carryover. Hmmmm!

c) T/P shut the insurance business down in 2012. In 2017 T/P once again starts an insurance business and makes \$25,000 in 2017.

\$2,500 - just as in b. T/P still has the carryover - We believe he can use it many years (and several homes) later!

d) T/P shut the insurance business in 2010. In 2013 T/P sells the home. Must the \$1,000 of depreciation be taken into account in reducing basis?

Yes, but a tough one to explain to a client. The depreciation was never "allowed". Income limitations suspended the deduction. Thus far, it has not been "allowable". However, the carryforward is still *available* for a future year – in fact, our prior question involved this precise situation – the depreciation produced a deduction years after the home was sold!.

SELLING THE HOME

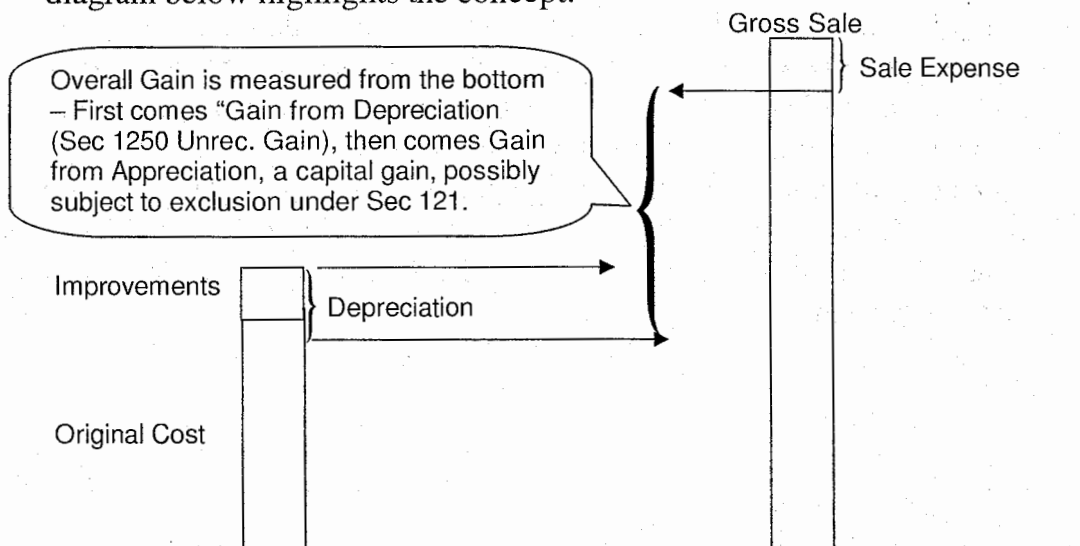
UPON SALE – “SINGLE DWELLING UNIT”?? – ALL IS WELL. Regulation 1.121-1 says if the property sold is a “single dwelling unit”, we may make full use of the Section 121 \$250,000 exclusion.

CAVEAT – DEPRECIATION AFTER 5/7/97. Any depreciation claimed after 5/6/97 cannot be excluded under any circumstances.

“ALLOWED OR ALLOWABLE” PARTIALLY SUSPENDED! Publication 587 states “If you used any part of your home for business, you must adjust the basis of your home for any depreciation that was allowable for its business use, even if you did not claim it. If you deducted less depreciation than you could have under the method you properly selected, you must decrease the basis by the amount you could have deducted under that method. If you deducted more depreciation than you should have under the method you properly selected, you must decrease the basis by the amount you should have deducted, plus the part of the excess deducted that actually decreased your tax liability for any year.”

SOLUTION (???) – DON’T CLAIM DEPRECIATION? We hear this advice often. Doesn’t work!! The instructions reiterate the long-standing “allowed or allowable” rule - - - if depreciation *would have been allowed*, we are required to reduce the basis (and claim the Section 1250 Unrecaptured Gain!!!) *whether you took the deductions or not!*

GAIN FROM APPRECIATION vs. GAIN FROM DEPRECIATION. When the home sells, we compare “Amount Realized” with “Adjusted Basis”. The diagram below highlights the concept.



BONUS! – HOME OFFICES & COMMUTING

REVENUE RULING 99-7 says: “If a taxpayer’s residence is the taxpayer’s principal place of business within the meaning of section 280A(c)(1)(A), the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the other work location is REGULAR or TEMPORARY and regardless of the distance.”

HOME = PRINCIPAL PLACE OF BUSINESS – NO OTHER REQUIREMENT

Yes, the Ruling is clear. As long as the home is the *principal place of business* for a particular business, any business driving for *that* business is fully deductible without regard to the normal commuting rules.

HOME OFFICE DEDUCTIONS NOT REQUIRED. The ruling only requires one to pass the principal place of business test. Taxpayer might refuse to claim the Home Office deduction, or simply not otherwise qualify (for example, the space might not meet the “regular and exclusive” test). Nonetheless, the home becomes a “work location” for purposes of commuting.

TAX HOME DISTINGUISHED. IRS makes a point that a home which passes the principal place of business test for a given trade or business might not qualify as taxpayer’s “tax home”. Tax home considerations affect one’s ability to claim meal and lodging expense for temporary assignments away from that tax home.

“SAME TRADE OR BUSINESS” ISSUES. The Ruling keeps adding “within the same trade or business” to all sentences about a trip to a work location. Some practitioners thought this was some new idea. In reality, this simply avoids the issue of dealing with trips between “work locations” for different trades. Take a self-employed tax consultant (with home as principal place of business) who also has a part-time job as an employee elsewhere. Suppose he drives from home to part-time job. Is he simply going to work? Is he allowed a deduction for “two jobs, same day”? If there is a deduction, where is it claimed – on Schedule C or Schedule A? These problems have always swung on “all facts and circumstances”. They still do.