

## Deducting the Costs of a Home Office

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To deduct the costs of maintaining a home office, a self-employed taxpayer must use the space exclusively and regularly as [IRC Sec. 280A(c)(1)]:

1. a principal place of business,
2. a place to meet or deal with clients and customers in the normal course of business, or
3. a place used in connection with a business if the space is a separate structure from the residence (such as a barn or detached garage).

Employee use. Employees may also claim home office deductions if the business use of the home is for the employer's convenience and the space is used exclusively and regularly for job-related activities [IRC Sec. 280A(c)(1)]. As a practical matter, it is difficult for employees to pass these tests.

Employees who "telecommute" a few days a week (work at home but access and share information using telephones, computers, fax machines, etc.) cannot deduct the cost of a home office unless the arrangement is for the employer's convenience. If the individual also has an office furnished by the employer, it is unlikely that working at home is for the employer's convenience (*Cadwallader*). Some employers have adopted a system of sharing office space known as "hotelling." Employees must reserve time in a shared office space when they need it for specific tasks (such as meeting clients). When not using the employer's office space, the employee works at home. This arrangement may be for the employer's convenience if, for example, its purpose is to save the employer overhead costs. In this situation, the employee should be able to deduct the home office expenses (if the other requirements for the deduction are met). Of course, it may be a hollow victory because such expenses are claimed as miscellaneous itemized deductions, which means they (along with other miscellaneous deductions) are only allowed to the extent they exceed 2% of the taxpayer's adjusted gross income.

**Note:** Employees cannot avoid the home office rules by renting the home office to their employer [IRC Sec. 280A(c)(6)].

### Home Office Requirements

Regular and exclusive use. Regular use means the taxpayer must use a portion of the home on a continuing basis. Exclusive use means the taxpayer must use a specific portion of the home only for business purposes. Personal use, even after business hours, causes the costs of maintaining the office to become nondeductible. There are two exceptions to the exclusive use rule: (1) storage of inventory (including product samples) and (2) certain daycare facilities. Space

in the home used for these two purposes can also be used for personal purposes [IRC Sec. 280A(c)(2) and (4)].

A home office doesn't need to be a separate room or permanently partitioned portion of a room. Any "separately identifiable" area can serve as an office [Prop. Reg. 1.280A-2(g)(1); *Weightman*]. Thus, a corner of a room with a desk and file cabinet could qualify as a home office while using the dining room table as a workspace generally would not (unless the table was never used for anything else).

A taxpayer can operate two or more businesses out of the home office and still meet the exclusive and regular use requirements. However, each business must independently meet the requirements to sustain the deduction (*Hamacher*). This normally presents a problem for employees who use a home office for employment-related duties and for a self-employment (i.e., sideline) business. If any of the activities fails the regular and exclusive use requirements, the home office deduction is disallowed for all activities.

**Example 1:** Doug is on the staff of an accounting firm. He occasionally brings work home for his own convenience during busy season and uses a room over the garage as an office. He also prepares tax returns on the side and reports the income generated on Schedule C as a sole proprietor. Doug meets the requirements of regular and exclusive use of the office space for his sole proprietorship. However, since he also performs work in the home office as an employee of the accounting firm for his convenience (and not for the employer's), no home office deduction is allowed.

Principal place of business. Of the three tests listed in {IRC Sec. 280A(c)(1) (principal place of business, meeting with clients/customers, and separate structure), the principal place of business test is normally the easiest one to meet. In the landmark 1993 *Soliman* case, the Supreme Court identified two primary factors for determining whether a home office qualifies as the taxpayer's principal place of business: (1) the relative importance of the activities performed at each business location and (2) the time spent at each place.

The "relative importance" test is analyzed first and, if no definitive answer is reached, the "time" test is considered. When analyzing the relative importance of the activities performed at each location, the point where clients are met or goods and services are delivered is given great weight. Whether the functions performed at home are essential to the business, while relevant, is not controlling, and the availability of alternate office space is irrelevant.

**Example 2:** Tyler is a self-employed writer who spends approximately 35 hours each week in his home office writing and an average of 15 hours per week at other locations doing research, meeting with publishers, and attending

promotional events. Tyler's home office qualifies as his principal place of business. His activities away from his office are less important and take less time than his writing, which is the essence of his trade or business (Rev. Rul. 94-24).

Beginning this year, the definition of "principal place of business" also includes a place that [IRC Sec. 280A(c)(1)]:

1. is used exclusively and regularly by the taxpayer to conduct administrative or management activities of a trade or business, and
2. is the only fixed location where the taxpayer conducts substantial administrative or management activities of that trade or business.

In the 1998 edition of IRS Pub. 587 (on page 24), the IRS helpfully notes that administrative or managerial activities include (a) billing customers, clients, or patients; (b) keeping books and records; (c) ordering supplies; (d) setting up appointments; and (e) forwarding orders or writing reports. It also notes that the following activities will not disqualify a taxpayer's home office from being a principal place of business based on the administrative or management activities performed there:

1. The taxpayer has others conduct some administrative or management activities at locations away from the home office. (For example, another company may do the billing from its place of business).
2. The taxpayer conducts some administrative or management activities at places that are not fixed locations of the business (such as in a car, a plane or a hotel room).
3. Minimal administrative or management activities are conducted by the taxpayer at a fixed location outside of the taxpayer's home.
4. The taxpayer conducts substantial nonadministrative or nonmanagement business activities at a fixed location outside of the home. (For example, the taxpayer meets with or provides services to customers, clients, or patients at a fixed business location outside of the home).
5. The taxpayer chooses to conduct the business's administrative or management activities in a home office even though suitable space outside the home is available for that purpose.

**Example 3:** Sheila is a self-employed anesthesiologist. She spends the majority of her time administering anesthesia and postoperative care in three local hospitals. One of the hospitals provides her with a small shared office where she could conduct administrative or management activities. However, she instead chooses to use a room in her home that she has converted to an office. The room is used regularly and exclusively to contact patients, surgeons, and hospitals regarding

scheduling and to prepare for treatments; to prepare and maintain billing records and patient logs; and to read medical journals and books.

Prior to 1999, Sheila is not entitled to a deduction for her home office expenses because the activities performed there are less important than the services she performs at the hospitals. However, beginning in 1999, her home office will qualify as a principal place of business because of the administrative and management activities she conducts there. Her choice to use her home office rather than the one provided by one of the hospitals does not disqualify her deduction.

**Example 4:** Tara is employed as a teacher. She is required to teach and meet with students at the school and to grade papers and tests. The school provides her with a small office where she can work on her lesson plans, grade papers and tests, and meet with parents and students. The school does not require her to work at home.

Tara prefers to use the office she has set up in her home and normally does not use the one provided by the school. She uses this home office exclusively and regularly for the administrative duties of her teaching job.

Prior to 1999, Tara's home office doesn't qualify as her principal place of business because the administrative duties performed there are less important than her teaching duties at the school. Thus, because the home office fails the principal place of business test, it isn't necessary to determine whether she maintains it for her employer's convenience.

Although her home office will pass the principal-place-of-business test after 1998, Tara still has to meet the convenience-of-the-employer. Because her employer provides her with an office and does not require her to work at home, she does not pass this second test so she is not entitled to a home office deduction.

A taxpayer with more than one trade or business can have more than one principal place of business. In *Curphey*, a home office deduction was allowed for a doctor who met the exclusive and regular use requirements for his second line of business, which was real estate rentals. His involvement in the real estate activity was significant enough to qualify as a trade or business.

### **Altering Business Activities to Qualify for Home Office Deduction**

Remember, a home office that's not a taxpayer's principal place of business can still qualify for a deduction if [IRC Sec. 280A(c)(1)(B) and (C):

1. it's used regularly and exclusively to meet and deal with clients, customers, or patients in the normal course of business, or

2. it is not attached to the house and is used regularly and exclusively in connection with the business.

Thus, taxpayers who can't meet the principal place of business test should consider arranging their business activities to meet one of these two tests if possible. For example, if the home is not the principal place of business, expenses incurred for a home office may still be deductible if the office is set up in a detached garage (or other structures not attached to the house).

### **Calculating the Office Deduction**

The home office deduction rules cover both direct and indirect expenses, including utilities, insurance, property taxes, and depreciation. Expenses that are deductible regardless of the taxpayer's trade or business activities (e.g., qualifying mortgage interest or property taxes) are unaffected by the limitations on the home office deduction.

Direct expenses (e.g., repairs made to the room used for business) are deducted in full (subject to the income limitation discussed in the next paragraph). Indirect expenses that benefit the entire home (e.g., utilities or depreciation) are deducted pro rata, based on the home office usage relative to total usage. In many cases, this allocation is based on square footage. Other allocations may be based on relative fair market value (FMV) when multiple structures are involved.

The deduction (with the exception of otherwise deductible items like mortgage interest and taxes) is limited to the business's net income [IRC Sec. 280A(c)(5)]. Thus, the deduction cannot create or increase a loss from the business. The limitation is determined by deducting the business use portion of the home office deductions in the following order: (1) business percentage of the expenses allowable as a deduction in any case (e.g., mortgage interest and property taxes), which are fully deductible even if they exceed the net income from the business; (2) other expenses such as repairs, utilities, and insurance; and (3) depreciation of the home office space (Prop. Reg. 1.280A-2(i)(5)). Excess expenses from categories 2 and 3 can be carried over to later years. However, the net income limitation applies in each succeeding year. [IRC Sec. 280A(c)(5)].

Sole proprietors deduct their expenses "above the line" on line 30 of Schedule C or line 34 of Schedule F. Form 8829 (Expenses for Business Use of Your Home) is required for Schedule C filers, but not for self-employment farmers (filing Schedule f).

**Caution:** A portion of most utilities that benefit the entire home (e.g., electricity or gas) can be deducted if the home office meets the requirements of IRC Sec. 280A. But the basic charge (including taxes) for the first telephone line provided to a residence is a nondeductible personal expense [IRC Sec. 262 (b)].

However, the costs of business long distance calls made on this line plus the business portion of any additional lines to the residence are deductible without regard to the home office deduction limit (i.e., they are deductible on line 25 or 27 of Schedule C or the appropriate line of Schedule F).

### **Home Office Expenses Recaptured If House sold at a Gain**

Taxpayers normally can exclude up to \$250,000 (\$500,000 for a married couple filing a joint return) of the gain on the sale of a principal residence (IRC Sec. 121). However, the exclusion doesn't apply to the extent of depreciation allowed or allowable because of the rental or business use of the residence for periods after May 6, 1997. Such depreciation is "recaptured" if the home is ever sold at a gain. Also, the portion of the home used as an office is tested separately to see if the taxpayer used it as a principal residence for two out of five years before the sale.

**Observation:** Taxpayers who expect relatively little benefit from the home office deduction and who anticipate selling their home at a gain may be tempted not to claim any home office deduction (for example, by using the home office for something other than business purposes). However, unless the taxpayer's tax bracket is less than 25% when the home office depreciation is claimed, the taxpayer is better off claiming the depreciation and recapturing its benefits when the house is sold (at a 25% rate). Also, considering the time value of money, a taxpayer is generally better off deducting expenses, even if they will be recaptured at roughly the same tax rate in the future. The taxpayer must consider, however, the potential loss of the exclusion for the portion of the gain attributable to the home office if it does not meet the two-out-of-five-year test for use as a principal residence.

### **Deducting the Cost of a Home Computer**

For self-employed individuals, a home-based computer and any related equipment designed to be placed under its control (such as a printer or modem) is fully deductible if used solely for business at a regular business establishment, which includes a qualifying home office [IRC Sec. 280F(d)(4)(B)]. The computer is either depreciated under MACRS depreciation (using a five-year life), expensed as a Section 179 deduction, or a combination of both.

An employee can also qualify to depreciate or expense the cost of a computer and related equipment used at home for business purposes. However, the use must be for the employer's convenience and required as a condition of employment [IRC Sec. 280F(d)(3)]. The IRS takes the position that the convenience and condition of employment test means the employer must

specifically require employees to buy a computer to keep their jobs. However, the Tax Court held that the test is satisfied when the computer purchase spares the employer the cost of providing the employee with suitable computer equipment with which to fulfill job responsibilities (*Cadwallader*). Unfortunately, even under this more liberal interpretation of the rules, it's difficult for the employee's to claim computer deductions because of the 2% adjusted gross income limitation on miscellaneous itemized deductions. Also, because of problems with getting proof that the employee's computer spares the employer the cost of providing another computer.

Regardless of whether it's used by an employee or self-employed individual, a computer used in a space that does not qualify for home office deductions is "listed property" [IRC Sec. 280F(d)(4)(A) and (B)]. In this situation, only taxpayers who use the computer for business more than 50% of its total use can claim a Section 179 deduction or regular MACRS depreciation [IRC Sec. 280F(b) and (d)(1)]. If the business use is 50% or less of the total use, IRC Sec. 179 does not apply, and depreciation is claimed on a straight-line basis over the five-year recovery period.

**Example 5:** Travis is a self-employed computer programmer who works exclusively out of his home. One room of his house is used as an office where he writes software, performs managerial tasks related to his business, and conducts any necessary meetings. This room would qualify for the home office deduction, except that it includes a TV his children occasionally use. This use disqualifies the space for home office deductions and makes his home computer listed property. However, as long as Travis's computer is used more than 50% for business purposes it remains eligible for MACRS depreciation and the Section 179 deduction.

**Variation 1:** Assume the same facts as above, except that in addition to watching TV in the office, Travis's kids also use his computer to do their homework and play video games. Their computer usage is 20% of the total time the computer is used. Thus, only 80% of the computer's cost is deductible. This 80% is eligible for regular MACRS depreciation and the Section 179 deduction.

**Variation 2:** Assume the same facts as in Variation 1, except that the children use the computer 60% of the total time it is used. Here, 40% of Travis's computer is depreciable, and the straight-line method must be used. Additionally, no Section 179 deduction is allowed.

If qualified business use starts out at over 50% but then falls below that level in a later year, a special recapture rule applies. The excess of depreciation and Section 179 deduction claimed in earlier years over the amount of depreciation

that would have been allowable using the straight-line method (over the same recovery period) is included in income (in Part IV of Form 4797). This amount is also added to the computer's basis. Depreciation in the year usage falls to 50% or less and in later years is claimed using the straight-line method [IRC Secs. 280F(b) and 168(g)].

**Observation:** A computer used in an area of the home that qualifies for a home office deduction is not listed property. Thus, a return that includes a computer as listed property (regardless of where the business use falls between 0% and 100%) normally should not also include a home office deduction (unless the computer is kept somewhere other than the home office).

Investment or income-producing uses. In addition to its use in an area of the home that doesn't qualify for home office deductions, a home computer is considered listed property if used for any of the following purposes {IRC Secs. 212 and 280F(d)(4)(B)}:

1. To assist in the production or collection of income (for example, to track investments).
2. To manage, conserve, or maintain property held for the production of income (for example, to help manage rental properties in an activity that doesn't qualify as a trade or business).
3. To assist in determining the amount of tax owed or due as a refund [for example, to help prepare the taxpayer's income tax return(s)].

A computer used for one of these purposes does not qualify for a Section 179 deduction, and depreciation is calculated using the straight-line method [IRC Secs. 179(d)(1) and 280F(b)(1)]. Any allowable depreciation is claimed as a miscellaneous itemized deduction, subject to the 2% of adjusted gross income floor [IRC Sec. 67(b); Reg. 1.67-1T(a)(1)(ii)]. Investment/income producing use cannot be combined with business use to qualify for regular MACRS depreciation and the Section 179 deduction [Reg. 1.280F-6T(d)(2)(i) and (3)(i)]. However, once a computer is predominantly (i.e., more than 50%) used in connection with a trade or business, regular MACRS depreciation and the Section 179 expense deduction are available for the combined business/investment use.

**Example 6:** Scott uses a home computer 35% of the time to manage his investments and 40% of the time in a business activity operated as a sole proprietorship. Because the computer's business use percentage is not more than 50%, it doesn't qualify for a Section 179 deduction and must be depreciated on a straight-line basis. However, to determine the depreciable basis, the business and investment use percentages are added together so that straight-line depreciation can be claimed on 75% (35%+40%) of the cost. [Reg. 1.280F-6T(d)(5), Example 1].

**Variation:** Assume the same facts as above, except that Scott's business use of the computer is 60%. Because the business use percentage exceeds 50%, the computer qualifies for a Section 179 deduction and regular MACRS depreciation based on 95% (35%+60%) of the cost [Reg. 1.1280F-6T(d)(5), Example 2]. Under either set of facts, the depreciation (or Section 179 deduction) related to the business use is claimed on Schedule C, and the investment-related portion is claimed on Schedule A.

Deducting the cost of software. When computer hardware and software are acquired together and the software's cost is not separately stated, the entire purchase price is treated as hardware costs (Rev. Procs. 69-21 and 97-50). Thus, the software costs are depreciated along with the hardware based on the hardware's recovery period (five years) or, if the taxpayer otherwise qualifies, expensed as Section 179 property.

If software is purchased separately or if its cost is separately stated, it is depreciable over a 36-month period, and Section 179 does not apply (because the software is not tangible property). The software's depreciation is computed on a straight-line basis beginning with the month the software is placed in service [Rev. Proc. 69-21; IRC Sec. 167(f)(1)].

Software with a useful life of less than one year or that costs less than the taxpayer's depreciation threshold currently may be deducted as a business expense. In addition, payments on leased software are currently deductible as a rental expense.

**Caution:** Although computer software is generally excluded from the definition of Section 197 intangibles, software that has been substantially modified and acquired in connection with the purchase of a business is considered a Section 197 intangible [IRC Sec. 197(e)(3)]. Section 197 intangibles are amortized over a 15-year period.

Noncomputer related equipment used in a home office. Office furniture and other noncomputer-related equipment used in a home office can be depreciated under MACRS or claimed as a Section 179 deduction to the extent it is used for business purposes. Because such items are not "listed" property [as defined in IRC. Sec. 280F(d)(4)], the business portion of the property can qualify for accelerated MACRS depreciation and Section 179 even if such portion is less than 50%. However, property converted from personal use to be used in a home office doesn't qualify for a Section 179 deduction-even though it still qualifies for MACRS depreciation starting with the year the business use begins. The beginning depreciable basis for such property is the lesser of its original cost or its value at the time of conversion from personal use.

## **Deducting Commuting Expenses**

The cost of transportation from a taxpayer's personal residence to his or her place of work is generally considered a personal, nondeductible expense [Regs. 1.162-2(e) and 1.262-1(b)]. However, the cost of travelling between several regular places of business (other than the home) should be deductible. (See *Steinhort and Heurer*; Rev. Rul. 55-109.)

Taxpayers who work at home can deduct some costs of getting from their home to other work locations. The types of trips that qualify for deduction depend on whether the residence qualifies as the principal place of business.

#### Deducting transportation when the residence is the principal place of business.

If the residence is the taxpayer's principal place of business, the cost of commuting from the home to other work locations in the same trade or business is a deductible business expense (Rev. Ruls. 94-47 and 99-7; *Wisconsin Psychiatric Services, Ltd. and Curphey*). Thus, arranging business affairs to qualify the residence as the principal place of business can convert what would be personal commuting expense to a deductible bus. expense.

#### Commuting expenses when the residence is not the principal place of business.

Taxpayers whose home office does not qualify as a principal place of business can still deduct the cost of travelling from their residences to temporary work locations outside the metropolitan area where they live and work. A work location is temporary if the work there is realistically expected to last (and does in fact last) for one year or less. A work location is also temporary if the work is temporary in the absence of facts and circumstances indicating otherwise. If work at a location is realistically expected to last for more than one year or there is no realistic expectation that it will last for one year or less, the work location is not temporary, regardless of how long the work lasts. If work at a location initially is realistically expected to last for one year or less, but at some later date it becomes obvious it will exceed one year, the work location is treated as temporary until the date the taxpayer's realistic expectation changes, and is treated as not temporary after that date (Rev. Rul. 99-7).

The IRS has said it will not follow the Tax Court's decision in *Walker*, which said travel from the residence to another work location is deductible if the home office qualifies as a "regular place of business" but not the principal place of business (Rev. Ruls. 94-47 and 99-7). However, in Rev. Rul. 99-7, the IRS did reconfirm that it will allow taxpayer's to deduct daily transportation expenses incurred in going from the taxpayer's residence to a temporary work location (regardless of the distance) if the taxpayer has one or more regular work locations (in the same trade or business) away from the residence.

### **Conclusion**

Expenses of a home office are deductible if the office meets certain criteria. After 1998, these criteria are relaxed, so that a home office can 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 may also yield additional deductible transportation expenses since the cost of commuting from the principal place of business (including a home) to other workplaces is deductible. Also, when the home office qualifies for a deduction (because it's a principal place of business, because the taxpayer regularly meets with clients there, or because the office is not attached to the home and business is conducted there regularly), a computer used in that office is fully deductible, with accelerated depreciation and the Section 179 deduction is available.