

## Rules for the Home Office

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If you are embarking on a new business, doing so creates a number of tax considerations. Among them is how to handle the location of your business. Some businesses will start small by operating out of the home. Others will lease or buy space away from the home. The off-site choice is simpler for tax purposes. The cost of the off-site space is deductible as rent or depreciable in the case of purchase; however, having a home office can create an even bigger problem because your home itself is a personal asset.

### Home Office Rules

For those of you who wish to have a home office, there's good news for you! Over the years, the IRS has eased up on the requirement of having a home office. While your home office must be the principal location of the business, the activity of the business need not be performed there; however, the office must serve a necessary function for the business. For example, a contractor who builds houses may have an office in his or her home. The office is not where the principal activity of the business is located, but it is necessary to have a location to complete estimates and billing, to make calls, or to receive correspondence. This is the function of the office in home.

Once you have established the business purpose of the location, the office itself must meet certain conditions. You must use it exclusively for business. In plain English that means personal items and personal business are off limits for the office. Personal tasks such as balancing the checkbook, writing personal checks, and playing video games are not allowed in the home office. It might seem unfair since people do those things in

their business offices all the time, but this is an example of the differences in the home office compared to the off-site office. In the home office the equipment, such as the computer, must be 100% for business use. If it is not, it will violate the exclusive use test. Alternatively, if you want to use the computer for non-business purposes, the computer must be easily moveable to a location outside the office. Having other personal items in the office space would also cast a doubt as to the exclusivity of the office. Items such as a couch would not be needed unless meeting clients in the office is normal. Family pictures on the wall might even be questionable. The more professional your business space is, the more believable it will be.

Your office itself does not need to be bound by four visible walls. It needs only to have the area used as the office contained in a specific portion of the room. It need not be the entire room. It is unnecessary to mark off a portion of a room with a permanent partition. The need to walk through the area to get to another part of the house will not disqualify the space as long as the other requirements are met.

### Tax Benefits of Office in Home

What is to be gained by having an office in your home depends on your particular circumstances. The property containing the office can be either owned or rented. If you own the property, the cost of the office space will be a fraction of the cost basis of the entire property. That fraction of the total will be depreciated over the life set forth in the tax law. Office space is considered commercial property with a thirty-nine-year

life, even though it is in the home. If you rent the property, a fraction of your rental payment will be deductible. The fraction is determined by measuring the dedicated office space and dividing that number by the total living area. If your office is on the first floor, the square footage of the basement area will generally not be counted. If your office is located in the lower level, the entire space must be counted. Once the square footage is determined and the math has been done, the business percentage is applied to the allowable expenses.

Your allowable expenses include not only the depreciation or the rent but also the utilities, property taxes, interest, and insurance. Generally, utilities are limited to gas, oil, and electricity. Water is not allowed unless your business needs water to operate. If you run a home-centered beauty shop, it would be allowed as a water expense since it is necessary for the activity. The mere need to have restroom facilities does not justify a water deduction.

The IRS has provided Form 8829 (Expenses for Business Use of Your Home) for the calculation. If an expense is exclusively used in the office area such as having a separate utility meter for the office space, that expense would be allowed in total. If the utility bill for the entire house is measured by one meter, the bill must be allocated using the fraction described earlier. If you make modifications to the space, these will be depreciated separately similar to the treatment of the dedicated utility meter.

## Other Benefits

If you are self-employed, the home office deduction can mean a double benefit. Income tax savings result from reducing the amount of taxable income. Self-employment tax is lowered by having a lower business income. Beyond that, having a qualified business location means the calculation of deductible mileage starts at home rather than at the first business stop after leaving

home. This can make a big difference, especially in these times of high energy costs. Even if the home office deduction is not allowed because your space is not exclusive, the mileage can still start from home if the office meets the business location test.

## Sale of Home Effect

If your home that has included an office is sold, the gain on the sale of the home may be excludable if the home has been owned and used as a principal residence for two of the last five years and the gain is not more than \$250,000 (or \$500,000 if MFJ). Any depreciation taken as part of the home office expense must be included in your income. This special rule applies when the office is contained within the home itself. If the office is set apart from the home, such as an office in a separate garage, the special exclusion will not apply.

## Employee and the Home Office

The office in home rules can also apply to your employees as well as self-employed persons. However, an employee must be required by the employer to have the office in home generally because the employer does not provide a space for the employee. The same calculation of area and expenses applies to the employee. The deduction itself is an itemized deduction as an employee business expense. It is subject to the two percent of AGI (adjusted gross income) limitation just as other employee expenses are. The key is the requirement that the office is used for the convenience of the employer.

## Day Care and the Home Office

If a day-care service is conducted in the home, the computation of the deduction is similar to that of any other business with two exceptions. The exclusive use test does not apply. A special rule allows the use of the entire property with the exception of any off-limit areas such as the master bedroom. The other

variation is the need to prorate the square footage of the used area by the entire area and by the hours used for day care compared to the hours in the year. It is necessary to keep a record of the children or adults cared for and the hours they were at the home. Additional hours used to prepare or clean up after the day care also are treated as day care hours.

One other difference in the day care calculation is the inclusion of water utilities necessary for the day care activity.

Below is a list of items to gather to complete the office in home deduction.

1. Dedicated Office Area
  2. Total Area
- Office Use Percentage (1 divided by 2)

### Hours Used for Day Care

3. Area Used for Day Care

### Expenses

- Home Mortgage Interest
- Real Estate Taxes
- Utilities
- Heat
- Electricity
- Water (In special cases only)
- Insurance
- Repairs
- Maintenance
- Improvements

The rules for having an office in the home are not complicated. Make sure you consult your enrolled agent as to what is best for you and your tax situation.

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