

Home Office Deductions – Are you Overlooking Some Real Tax Savings?

Do you have your office or run your business from home? Are you taking a home office deduction? Or, like many business owners, do you have an uneasy feeling that taking certain deductions would be like sending an invitation for an IRS audit?

You're not alone. According to a recent CNN article, nearly 44 million people regularly work at home. These include both businesses in the home and "telecommuters" - employees who work at home full and part time. Yet the latest numbers available from the IRS (2002 tax year) show that only 2.5 million taxpayers claim home office deductions - less than 20% of at home workers.

It's possible that many people who work at home don't qualify to deduct expenses for business use of a home. But maybe some of you aren't taking the break the government is offering simply because you don't know the rules. While we all are required to pay our taxes, you should never shy away from taking any legal deduction that can help lower your tax bill!

What are the rules?

According to the IRS, if you use a portion of your home "exclusively" and "regularly" for business purposes you can take a home office deduction.

Exclusive use. Exclusive use means you use a portion of your home only for business. That could be an office, showroom or other business use. However, if you use a room of your home for business *and* personal purposes, you won't meet the exclusive use test. So, if you use that spare bedroom as an office, get that bed out of there! The deduction is probably worth the trouble.

Note: The IRS has provided one exception particularly useful for distributors: You can deduct expenses related to the storage of inventory or samples even if you use the storage area for other things. The items have to be stored in a particular place -- your garage, for example, or a closet (as opposed to all over the house), you must use it regularly for storage, and your home must be the only location of the business. You don't qualify for the deduction if you have an office or other business location outside of your home.

If your home office is a separate structure that is not attached to your residence, you may qualify for the home office deduction without meeting the exclusive use requirement. In this situation, the structure merely has to be used in your trade or business.

Regular Use. The IRS doesn't define regular use -- only states that you must use a part of your home for business on a continuing basis, not just occasionally. You can probably meet this test easily.

Principal place of Business. If your only office is in your home, then you probably are "home" free. Your home automatically qualifies as your principal place of business if 1) you perform the management activities of your business from home, and 2) you don't

conduct those activities anywhere else. You may spend large portions of your work time seeing customers outside of your home office (even working in your car or a hotel room), but you still qualify for the deduction if you take care of most of the administrative activities at your home office location.

If you qualify for the home office deduction you also get more liberal rules for deducting auto expenses. You can generally deduct the cost of traveling from home to any business destination. This includes another place of business (such as a client or project location), or a destination such as a bank, post office, supplier, etc. Without your home as a principal place of business, travel to the first destination and travel from the last business destination home is considered non-deductible commuting expense. It makes a difference!

What if you are an employee? As an employee, you are eligible for deductions if you are using your home for the convenience of your employer. If the main office of the company is in another state and you are required to work from home to call on clients you would probably qualify. If, on the other hand, your employer provides you with office space elsewhere, and you asked to work part-time at home as a perk, you can't take the home office deduction.

What can I deduct? The "home office deduction" is really a basket of deductions. Assuming you have a qualifying home office, the IRS allows you to deduct a portion of your home's expenses, including mortgage or rent, insurance, repairs, utility bills, mortgage interest, improvements (if they relate to the part of the house you use for business), property taxes and depreciation on your home's purchase price. You are eligible whether you rent or own. Any repairs or improvements must be related to the portion of the home used for business. Plumbing repairs to a bathroom attached to the office and used by employees? Most likely deductible. A new stove that you use one burner consistently to make tea for employees? Not a chance.

Some deductions are available even if you don't qualify (or don't want to bother with) the home office deduction. If you don't meet the rules, you can still deduct ordinary and necessary business expenses that arise at your home --for instance, long-distance phone calls, a separate business telephone line, and the cost of office supplies and equipment. You may be able to depreciate the cost of computers and office furniture you buy to use at home, even if you're not allowed to deduct the cost of the office itself.

How to calculate the deduction. There are a couple of methods for figuring the percentage of your home used for business. You can take the square feet of the area used for business and divide that number by the total square feet of your home. Or, if the rooms in your home are close in size, you can divide the number of rooms used for business by the total number of rooms in your home. Working the calculation both ways will tell you which method gives you the best deduction, and yes, you really are allowed to pick the one that gives you the best answer! Once you have chosen that percentage you must apply it consistently every year.

You compute the annual depreciation expense on your home by dividing the purchase price by 39.5 and multiplying that amount by the percentage of your house used for business.

If you rent, you can multiply your annual rent payment by the percentage of the total space occupied by the office. You can also apply that prorated portion to utilities, insurance, repairs and maintenance.

For the self-employed, home office deductions, other than mortgage interest and real estate taxes, may not exceed your self-employed net income reported on Schedule C. If home office deductions exceed net self-employment income, those deductions may be carried forward the next year and deducted, but only if you have sufficient net income.

When you sell the house. In the past, the IRS had a rather large “gotcha” at sale time for home offices and the catch was called capital gains tax. Happily that problem has been eliminated, but there is still tax due on any depreciation which you took as part of the home office deduction. However, if you buy a new house that costs as much as or more than the house you are selling, AND you take the same percentage of space as a home office in the new house, even that tax can be deferred. Many specific requirements as to timing and price of the home must be met for this to work so, kids, don’t try this at home! To achieve the desired tax results, the sellers must meet IRS home sale exclusion requirements. Professional help is recommended.

Forms to use. If you are *self-employed*, use Form 8829, Expenses for Business Use of Your Home, to figure your home office deduction and report those deductions on line 30 of Schedule C, Form 1040. *Employees* can use the worksheet in Pub. 587 to figure their allowable expenses and claim them as a miscellaneous itemized deduction on Schedule A, Form 1040. For employees there are limitations to home office deductions based on income. The taxpayer must be able to itemize deductions. The home office deductions -- along with other miscellaneous deductions -- must exceed 2 percent of your adjusted gross income.

The Safety Net. To give yourself a little insurance (and sleep nights) always run your plans in front of a qualified tax professional. Also, be ready to prove, if necessary, that you have an office-in-home. You could photograph your home office clearly showing your desk, office equipment and files. Keep the pictures in your tax folder. Other simple steps such as having a separate phone line for the business and having business mail sent to your home can establish credibility. And remember, you can take a deduction for that second phone line!