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HOME OFFICE DEDUCTION

Having your own business and working out of your residence affords you the possibility of taking an office in home deduction against qualified business net income. The tax saving benefits of this deduction involve write-offs associated with this deduction. If you qualify for it, you may be entitled to take a portion of your utilities, certain maintenance and repairs, residence insurance, property taxes, and mortgage interest. If you rent, a portion of the rent may be deducted. If you own, a portion of the house cost and house improvements may be deductible through an allowable depreciation write-off.

But you must qualify for this deduction; that is, you must meet certain tests. These tests have changed in 2000, such that the home office deduction will be considerably easier to take. In summary, the requirements are as follows:

You must use a part of your residence regularly and exclusively for business purposes. Exclusively means a certain portion of the residence—a room, or a section—is used only for the business. Thus, you can't write-off the dining room table, or any part of the residence which is also used for non-business purposes. There is a possible exception here if you are using the residence for a daycare center. In that case, the "exclusive area" qualification may be replaced with a "time-used" calculation formula.

The home office must be the PRINCIPAL place of business. This is where it can get tricky. It's not so tricky if this home office is where you meet or deal with your clients in the normal course of your business. In that case, it definitely should qualify. Similarly, if the space is used for inventory storage, or as a qualified day care business, or if the office is a separate structure on your property, then the IRS should accept this as the principal place.

However, it can be complicated beyond this. The IRS position on principal place revolves around the amount of time spent in the home office compared to every place else. Second, the "relative importance" of the activities performed in the office compared to every place else.

So, if your business involves visiting clients, potential clients, or any other activities where you leave the home office, the burden rests with you to prove you meet these two tests.

The amount of time spent in the home office vs outside of it involves a ratio of total hours in the home office compared to total working hours. So, if you work 40 hours per week in your business, and spend 30 hours in your home office, and 10 hours outside, you meet the time test. How you prove this in case of an IRS challenge is still not officially clear; the Supreme Court did not set any rules here. Consequently, the proof most IRS districts seem to be accepting is a form of a time diary. That is, designating the time spent in the home office and out of the office.

The second test can be the most frustrating, and it can even override the first test of time. This test centers around your being able to prove the relative importance of your business activities both in the home office and out of it. This test involves the actual nature of the business. If the activities spent outside the home office are the true essence of the business, then even if you spend most of the time in the office, you will not get to take the deduction.



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For example, a telemarketer spends 25 hours per week making sales phone calls from his home office, and 15 hours per week outside doing business errands. In this case, since the essence of the business is telemarketing, and more than half the time was spent in the home office, the home office would qualify. In effect, the IRS has said that, if the activities being performed have equal relative importance both outside the home office, and inside the home office, then the time test is the determinant. However, if the activities are unequal in terms of business essence, then the main test is where the most important, principal activities are being performed.

Effective January 1, 1999, the "principal" place of business definition has been widened to include administrative use (such as paperwork). Also, if there is no other fixed location, then the "relative importance" and "time test" determinants may be waived. That means an office in home deduction may be easier to qualify for than has been the case in recent years.

Again, however, if clients come to the home office, or inventory storage is an important function, then the probability of a home office write-off is excellent.

How The Home Office Space Is Calculated

Assuming your business is eligible for the office in home deduction, let's review how the actual deduction is calculated. The first step is to arrive at the allowable deductible space. This can be done using two main methods for businesses other than a daycare facility.

The first option is to use a room to room comparison. You add up the total number of rooms in the house (usually not including bathrooms) used exclusively by the business compared to the total number of rooms in the house altogether. That gives you a percentage. So if you use 1 room out of 6, the office in home deduction percentage is .1667, or 1/6 of the total.

The second main method involves square footage comparisons. Add up the total square footage of space being used for the business compared to the total square footage of space in the entire residence, and you get a business use percentage. If the business square footage is 200 square feet, and the entire house square footage is 2000 square feet, the home office percentage would be 10%.

Note that the more square feet of business space you use, the bigger the deduction. So don't forget to consider all the useable, qualified business space, including attic, garage, and basement. In some unusual cases, businesses run out of the home can take up a majority of the useable square footage, thus creating a significantly large write-off.

This home office percentage is then used to determine the amount of deduction for the allowable expenses. You would add up the allowable utilities, insurance, maintenance costs, and any other similar operating expense, plus the allowable property taxes and mortgage interest. You then take the calculated office in home percentage to arrive at the allowable business write-off for this portion of the home office.



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In addition, the same home office percentage is used to calculate the portion of the rent you are paying (if you rent), or the deductible portion of the depreciable basis of the house itself (if you own it). If you own the residence, the calculation involves taking depreciation on the house based on IRS allowed write-off periods. Even if the house is going up in value—or appreciating—you can do this. The theory here is that "wear and tear" is occurring to the physical part of the house so the business should be allowed to factor it in as an expense.

Some Caveats

Although the office in home can generate some terrific 2000 tax deductions, and save you a significant amount of money, there are some possible drawbacks.

First, the office in home is a possible "red flag" in terms of audit possibilities. The deduction on the tax return does indeed stand out "like a sore thumb." Naturally, you should never fail to consider taking a legitimate deduction out of fear of an audit. However, this particular deduction may indeed increase your chances of an audit, especially in certain professions.

Second, parts of the office in home deduction may be subject to recapture down the road. The depreciation taken on the residence over time may be recapturable. This could increase your potential capital gains on the property upon sale. For decision-making purposes, this means you are comparing the dollar amount of tax savings by taking the office in home against possible tax "give-backs" upon the sale of the property. So, the effective tax bracket you are in while taking the current office in home deduction compared with what it will be when you sell becomes an important issue.

Conclusion

Taking an office in home deduction can make for some significant tax savings. For an unincorporated business it can mean tax savings for both income tax and self-employment taxes—a double whammy so to speak. At the upper brackets, this can be a savings in excess of 50% of every dollar spent in this regard.

So it's worth serious consideration. Similarly, if the deduction is taken, it's important to keep adequate records for the use of space comparisons, actual expenses, and relative importance of the business activities inside and out of the office in home. If done properly, it can be a great "loophole."