OCTOBER 2000 | Income Tax | PUBLICATION 1432

A Reprint from *Tierra Grande*, the Real Estate Center Journal

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Advantageous home office deduction rules went into effect in 1999. Two years earlier, the gain exclusion for sales of principal residences was expanded, also to the benefit of taxpayers. It was not until this year, however, that tax advisors began to fully appreciate how these two sets of rules combine to create tax benefits exceeding initial expectations.

Prior to 1997, if a principal residence with a home office was sold at a gain, the entire portion of the gain associated with the home office was taxable, even if the rest of the gain was excluded under the sale-of-principal-residence rules. Current law only taxes the home office part of the gain **to the extent of depreciation deductions on the home office after May 6, 1997**. The rest of the gain is excluded, up to $250,000 ($500,000 for married couples filing jointly.) Some conditions apply for this exclusion.

See the example. Assume a principal residence (excluding land) costs $100,000. The home office portion of the residence comprises 15 percent of cost, or $15,000, based on the number of square feet. During the holding period, a total of $10,000 is deducted in depreciation on the home office, reducing its tax basis to $5,000 ($15,000 less $10,000). At the end of the holding period, the home is sold for $150,000 (excluding land value) and 15 percent, or $22,500, is deemed to be the value of the home office.

Under old tax law, the taxable gain would be $17,500 ($22,500 less $5,000 home office tax basis). At a 28 percent pre-1997 capital gains tax rate, the gain would result in a $4,900 tax. Under current tax law, the tax is only $2,500 — a savings of almost 50 percent. The new law only taxes gain to the extent of depreciation, $10,000 in this example. Moreover, the capital gains tax rate on gain attributable to real estate depreciation deducted by noncorporate taxpayers is 25 percent, rather than the pre-1997 rate of 28 percent. Thus, the tax is $2,500 (25 percent of $10,000).

As shown in the example, the new rules provide an added incentive to establish a home office for tax purposes. The net tax savings from a home office are now higher because the tax cost of the office (computed on the gain at the time the home is sold) is reduced.

Where do the tax savings come from? In addition to annual depreciation deductions, homeowners can also deduct the annual cost of utilities and insurance associated with the home office, which would be 15 percent in the example. Supplies and other expenses directly related to the home office are fully deductible. Of course, property taxes and home mortgage interest are deductible as an itemized deduction regardless of whether there is a home office, but if a person is self-employed, it may be more advantageous to apply them pro-rata to the home office.

A potential indirect benefit of the home office deduction is that it enables the taxpayer to have deductible business mileage at 32.5 cents per mile for all auto travel to and from the home and other business locations. If a salesperson travels 1,000 miles during the year to business locations and back home, a $325 deduction is generated.

Example

Description	Amount	Source/computation
Cost of residence structure	$100,000	assumed
Home office portion	15%	assumed
Home office cost	$15,000	$100,000 x 15%
Home office depreciation	$10,000	assumed
Sale price of residence structure	$150,000	assumed
Home office portion of sale	$22,500	$150,000 x 15%
Home office tax basis	$5,000	$15,000 – $10,000
Old law taxable gain	$17,500	$22,500 – $5,000
Old law tax at 28%	$4,900	$17,500 x 28%
New law taxable gain	$10,000	limited to depreciation
New law tax at 25%	$2,500	$10,000 x 25%
New law tax savings	$2,400	$4,900 – $2,500

The criteria for a valid home office for tax purposes are complex. They are explained in a previous *Tierra Grande* tax column, "Home Office Deduction Eased" (July 1998). Rules for sales of residences are described and illustrated in "New Rules for Principal Residences" (*Tierra Grande*, January 1998).

Tax planning for home office deductions and sales of residences can be complex. Consultation with an accountant is recommended.

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Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $30 per year.