HOME WORK TAX PERK

BY JERROLD J. STERN

The home office deduction can save taxes for salaried individuals and self-employed people such as real estate professionals. To qualify, the office must be used "exclusively" and "on a regular basis" for either the entire business or its administrative and management activities. A 2012 tax court decision draws attention to taxpayer mistakes that can limit or eliminate the deduction.

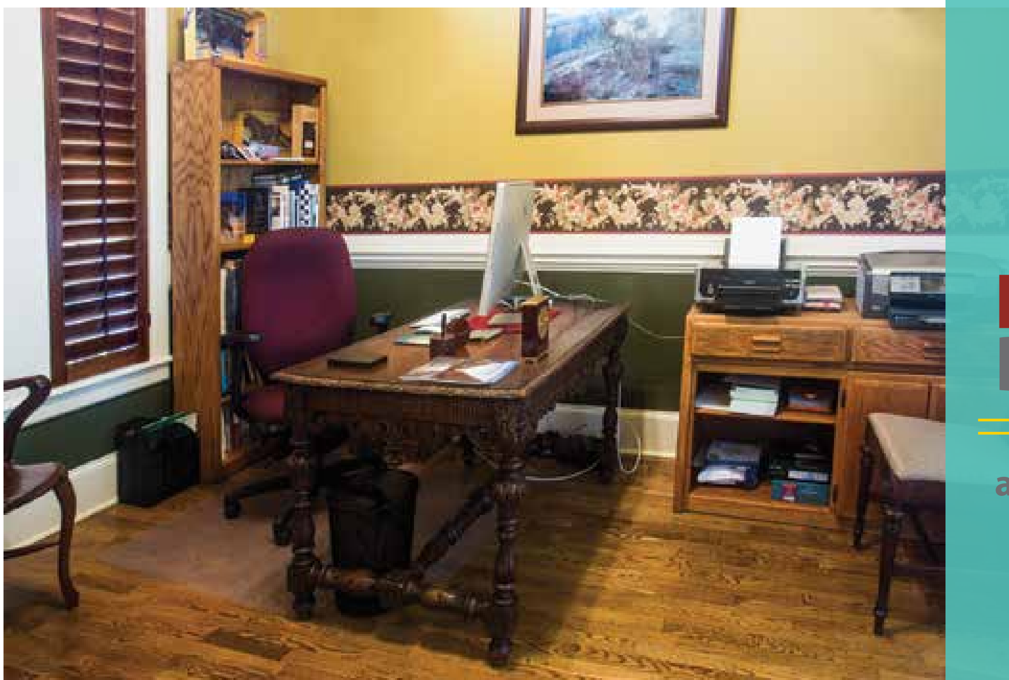
The "regular basis" test is met if business usage is continuous throughout the year. Incidental or occasional use is not sufficient.

To satisfy the "exclusive use" test, additional criteria apply. The home office area must be used *only* for the business. Unrelated activities will disqualify home office deductibility. Examples of disqualifying activities include nonbusiness use of a computer in the room (such as surfing the web for nonbusiness purposes or reading/writing nonbusiness email), paying household bills, and entertaining friends. Occasional use of the family den or kitchen table for work-related activities, such as the preparation of business documents or business-related reading, does not qualify for deduction purposes.

Fully deductible items include business supplies, painting, separate business phone, business computer, and housecleaning services for the office. Also deductible are the "business use percentage" of typical homeowner expenses such as homeowners insurance, utilities, rent and a security system. For homeowners, the business portion of the cost of the home can be written off each year (depreciated). However, if the home is sold for a profit, all of the depreciation will be taxable as a capital gain. The capital gains tax rate depends on the homeowner's marginal tax rate on ordinary income.

The "business use percentage" is the percentage of the home devoted to the home office (including business storage). There are two computation methods. For example, if there are five rooms in the home and one is a home office, then the business percentage is 20 percent regardless of the size of the rooms. Alternatively, the percentage of the home office floor space relative to the home's total floor space can be used.

In a 2012 tax court case, a married couple's 100 percent business use percentage was reduced to 16 percent by the IRS and upheld in court. According to the case, the taxpayers claimed that the percentage should be 100 percent "to reflect storage space, floor space under furniture and equipment [computers and a copy machine] located in combined use areas, and bathrooms connected to their offices." However, the IRS determined that personal records were stored in a



FULLY DEDUCTIBLE

– business supplies
– painting
– separate business phone
– business computer

NOT DEDUCTIBLE

anything shared with home
– bathroom
– table
– computer
– copy machine

closet and on computers the taxpayers treated as business property, thus disqualifying them.

The IRS also states, "A table, a computer, or a copy machine located in a room that is used both for business and personal purposes may be occasionally used for business, but [such] dual use of pieces of furniture or equipment does not satisfy the exclusive use test. Nor does occasional business use of a room, such as a bathroom which is also used for personal purposes, satisfy" the exclusive use test.

Home office rules allow deductions for rooms and separately identifiable areas in a single room, such as a desk and bookshelf in the corner of the room. Closets and storage areas are considered part of the home office (leading to larger deductions) if they are used exclusively for the business. Thus, such areas may be used to keep office supplies and real estate "for sale" signs. Amounts paid for business long-distance phone calls as well as the cost of a second phone line that is exclusively for business are deductible even if the taxpayer does not qualify for a home office deduction. The cost of a dual-use cell phone is not deductible.

Home office deductions are also available even if the home office is used exclusively for administrative/management activities for work performed outside the home. This rule can be used by real estate professionals who do not have any other office available to them. Minimal use of an office outside the home is allowed.

For 2013 and later years, the IRS recently announced that taxpayers can opt to deduct $5 for each square foot of home office space. However, since the maximum deduction under this method is $1,500 (300 square feet × $5), taxpayers should compare the deduction using all methods.

IRS publication 587, "Business Use of Your Home," is accessible at www.ustreas.gov and provides further explanation and examples of home office rules. For specific advice, especially regarding the choice of computation method, consultation with a tax accountant or tax attorney is recommended.

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THE TAKEAWAY

Real estate professionals and other taxpayers who have home offices can save taxes if IRS requirements are met. A 2012 tax court case illustrates potential pitfalls.

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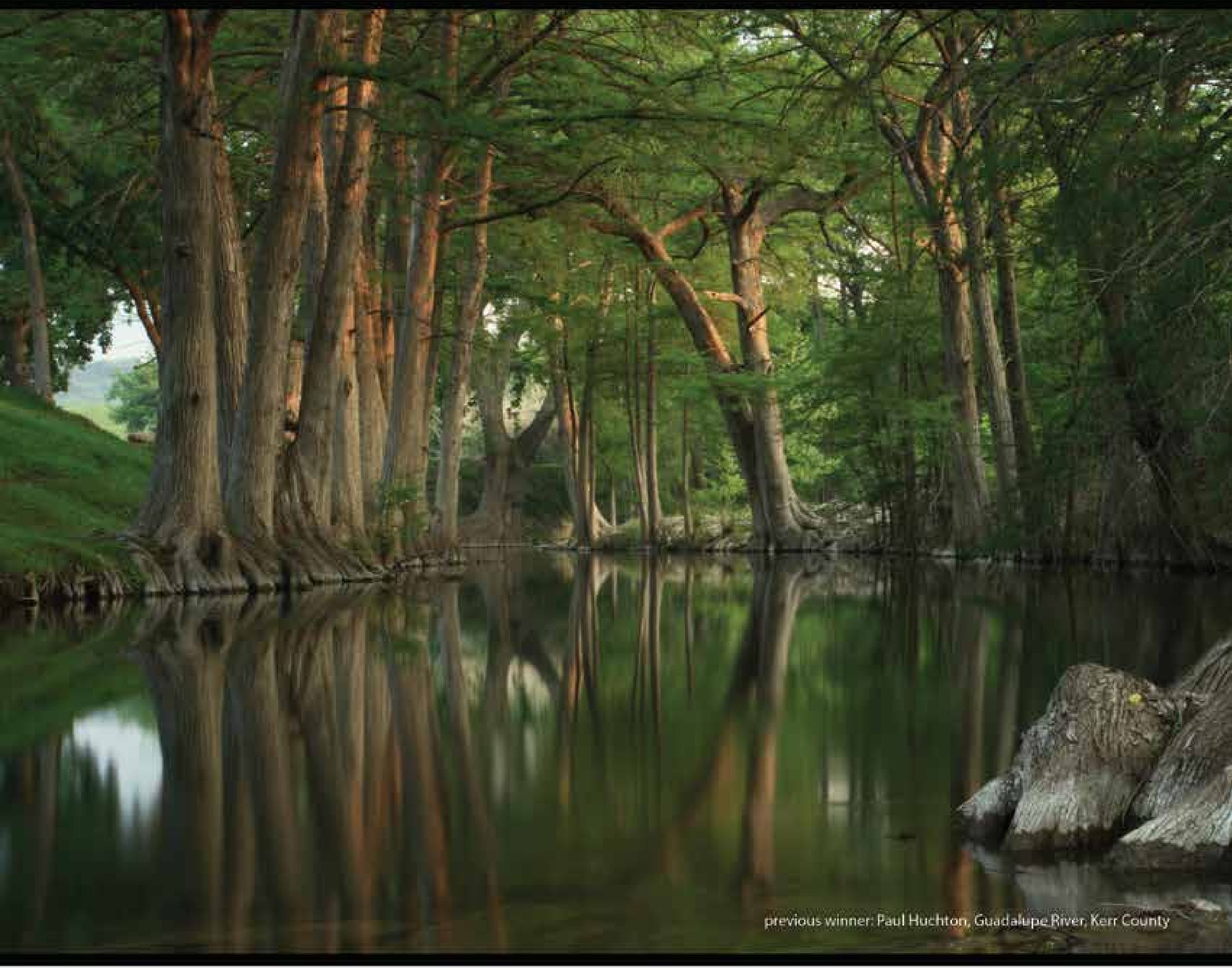

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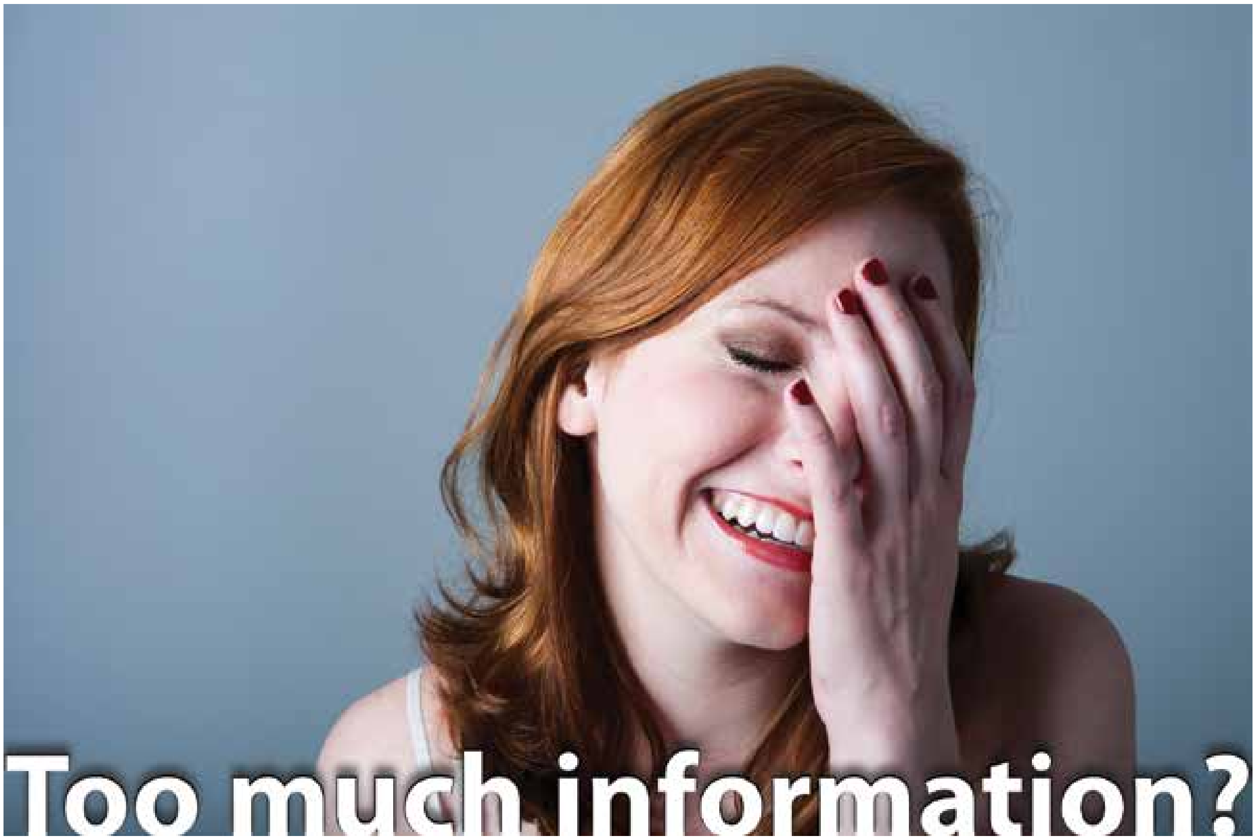

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