

Deductions for Business Use of Home

Approximately 53% of all small businesses are home based, and home-based businesses are a \$247 Billion a year industry¹. If you're running a business from your home, you already know some of the advantages – casual dress code, easy commute, flexible hours, and low overhead! There can also be significant tax deductions for the expenses of a qualifying office in home. *Note:* The content of this presentation is general in nature and based on authorities that are subject to change. It is not intended and should not be construed as legal, accounting or tax advice or opinion provided by SOS Business Services. If you have questions about your specific tax situation, *always* consult your tax advisor or the IRS.



Which Business Expenses are Deductible?

Like most tax questions, the best answer to this is “it depends.” There is no simple, complete answer to what business expenses you can and can't deduct. Generally, anything you spend or use to make taxable income is *probably* tax-deductible. This includes not only money you spend on things like advertising, but items you own, like your car or home, that you use for business. However, there are exceptions – for example, the IRS explicitly prohibits claiming the cost of the *primary* phone line into your home as a business expense.

What's a Qualified Home Office?

Generally, a qualified home office is an area of your home that is used **regularly** and **exclusively** as your **primary place of business** or **where you meet or deal with clients in the normal course of business**. Although the term office in home is used to describe deductible business use of your home, you may have deductions for areas other than an office (for example, a workshop or area used to store inventory). Note that for employees to claim a home office, they must also prove that the office is for the *employer's* convenience.

Regularly – not used on an incidental or occasional basis (for example, making toys for sale in your garage for a few weeks in December)

Exclusively – generally, your home office must be used *only* for business. (for example, your kids don't use the computer in your home office to do their homework). There are exceptions:

- ⇒ Daycare – daycare providers can claim the home office expense based on the amount of time their home is used as a daycare even though it's used as a daycare less than 100% of the time.
- ⇒ Used to store inventory – an area in your home that you use regularly to store inventory or samples can qualify as a home office even if it's not used exclusively if:
 - Your in the business of selling products either wholesale or retail
 - Your home is your only fixed location of your business *and*
 - The space used is a separately identifiable space suitable for storage

Primary place of business: A qualifying home office is the primary place where you conduct your business. You may have a qualifying home office even if you conduct your business in other places as well if:

- ⇒ Your home office is where the majority of your time or the most important of your business activities is performed *or*
- ⇒ You use your home office regularly and exclusively for administrative or management activities (e.g. scheduling, billing, keeping books and records, etc.) and you have no other fixed location where you

¹ <http://news.nase.org/news/homebased.asp> statistics as of 2000

conduct substantial administrative or management activities

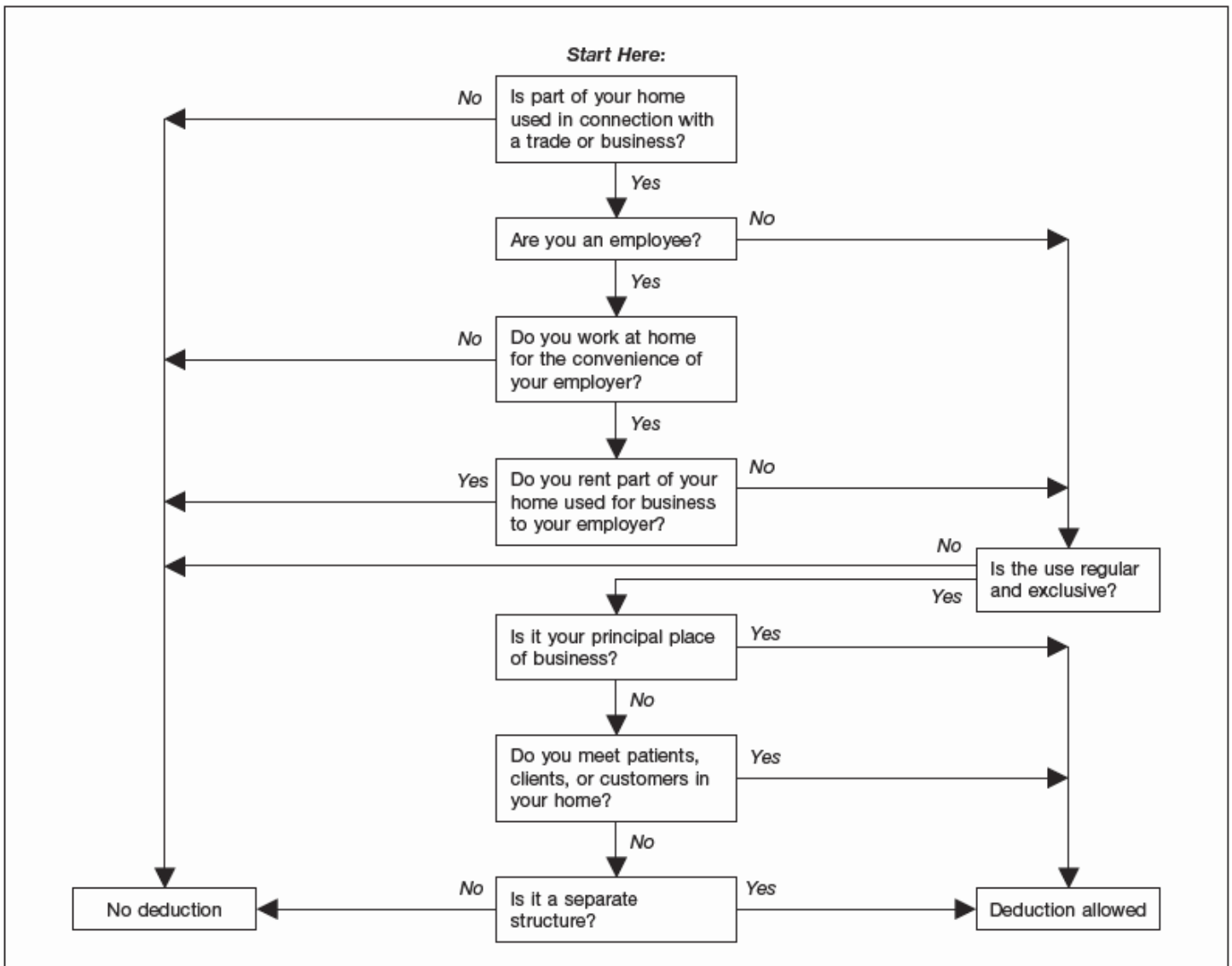
For example: An anesthesiologist consults with patients and administers anesthesia at several nearby hospitals. However, his home office is the primary location where he handles his correspondence, billing, appointments, and continuing professional education. He has a qualifying home office.

Used to meet patients, clients or customers

Even if you have another place of business, if meeting clients in your home is a substantial and integral part of your business, you may still have a qualifying home office.

Separate Structure

A separate structure used regularly and exclusively for business can be a qualified home office even if it's not your primary place of business or used to meet clients.²



² Discussion of qualified office in home and flowchart from IRS Pub 587 "Business Use of Your Home"

What Can You Deduct³

A qualified home office allows you to deduct the **business percentage** of indirect (i.e. expenses for your entire house, including your home office) expenses like:

- \$ Mortgage interest and qualified mortgage insurance premiums,
- \$ Property taxes,
- \$ Casualty or theft losses
- \$ Rent
- \$ Insurance
- \$ Most utilities (remember the basic cost of the first telephone line into your home is excluded),
- \$ Depreciation on your home and many home improvements,
- \$ Repairs and maintenance.

With the exception of qualifying mortgage interest, property taxes and casualty or theft losses, this deduction cannot be more than your gross business income from your office in home, but if your home office expenses exceed your business income, you can carry over excess deductions to claim the next year.

Generally, the **business percentage** is calculated by dividing the square footage of your home office by the total square footage of your home. For example, if your home office is 240 sq ft and your home is 2,400 sq ft, your business use percentage is 10%, so you would be able to deduct 10% of the expenses above (assuming income limits don't apply)

Direct expenses (expenses only for the business part of your home, like painting or repairs in your home office) are generally deductible in full. Expenses that are for a part of your house other than your home office, for example, painting your kids' room, are not deductible at all.

What Else Can You Deduct

Commuting mileage (mileage from your home to your place of business and back) is generally not deductible. For self-employed taxpayers, mileage to their first business stop of the day and home from their last business stop of the day is considered commuting mileage unless an exception applies. However, when you leave your **home office** you are traveling from one place of business to the next and all the mileage is deductible.

What Else Can You Deduct

For tax purposes, depreciation allows you to deduct a portion of your **basis** (generally what you paid for an item, but there are special calculations for inherited items, items given to you, and items converted to business use). Not only can you claim the business use percentage of depreciation on your home office, but you can also depreciate durable items that you purchased or converted to business use.

Top Five Reasons to Leave the (Home) Office:

- 1) I feel like I live at the office. ... Wait, I do!
- 2) I could die here and no one would ever know
- 3) It's 4pm and I'm still in pajamas
- 4) My family thinks I need to get a job
- 5) I want to hire an assistant, but we'd have to share a chair

<http://www.inc.com/resources/solo/articles/20060501/landers.html> "When It's Time Leave the (Home) Office" by Jeff Landers

³ Discussion of indirect expenses and business percentage from IRS Pub 587 "Business Use of Your Home"

What's the Upside?

Marion K. Ashe owns a home-based business that formulates and sells cosmetics. She takes the standard deduction for a single taxpayer and has no other income. In 2008, she sold \$60,000 worth of products that cost \$30,000 to produce. In addition she spent:

\$3,800 on advertising
\$2,000 on office supplies
\$6,000 on a marketing consultant and had
\$1,308 in deductible business miles⁴
Leaving her with a profit of \$16,892 and a tax bill of approximately:
\$675 in income tax⁵ and
\$2,387 in self-employment taxes for a total tax bill of **\$3,062**

Then, Marion realizes that she has a qualifying 60 square foot office in 600 square foot home. Her expenses include:

\$6,000 in rent
\$2,400 in utilities
\$ 600 in renter's insurance for
\$9,000 total. With a business use percentage of 10% (60 square feet/600 square feet) she has a \$900 home office deduction

Now she owes approximately:
\$591 in income tax and
\$2,260 in self-employment taxes for a total tax bill of **\$2,851** – a savings of \$211

If the home office means that she has an additional 50 deductible business miles a month, her savings are now \$288. Add \$485 in depreciation on a desk, shelves, and office chair that she converted to business use, and her savings are now \$401 – *without spending a single additional penny.*

What's the downside?

If certain conditions apply, you don't have to pay tax on the first \$250,000 in capital gains when you sell your primary residence. Since a qualifying home office was used for business, it has been argued that it was no longer a primary residence so the exclusion did not apply to any capital gains that could be allocated to the home office. For example, if you made \$60,000 on the sale of your home and \$6,000 was allocated to your home office, you could only exclude \$54,000. Since 2002⁶, for a home office that is part of your primary residence (not a separate structure), the only gains that cannot be excluded would be any gains due to depreciation. This generally isn't a big tax hit, because nonresidential property is generally depreciated over 39 years and home offices tend to be a small portion of the home (for example, if you used 10% of a \$90,000 house (building portion only) for all of 2007, the taxable income when you sold the home would be \$222 – or tax of approximately \$33 in the 15% tax bracket).

⁴ 200 miles per month at 50.5¢ per mile before July 1 and 58.5¢ per mile after July 1st

⁵ \$16,982 less ½ of self employment tax (1,194) for an adjusted gross income of 15,699. Less 5,450 standard deduction and 3,500 personal exemption (2008 figures) for a taxable income of \$6,749 – income tax of approximately \$675 at the 10% tax bracket

⁶ <http://www.deadlinenews.com/capgains.html>

Hiring employees for a home-based business:

1. *Do your homework:* Familiarize yourself with your state employment laws and local zoning laws. Consult with your insurance agent before hiring an employee – California requires most employers to carry workers' compensation, and standard homeowners' policies may not cover losses resulting from having employees in your home.

2. *Set the ground rules:* Determine what compensation you can afford to offer, what work your employee will be doing, and how much access they will be allowed in your home. Talk to other household members about an employee coming in and make sure that everyone understands that your employee is there to work. Household members have no obligation to feed, entertain, or otherwise treat your employee as a guest.

3. *Practice due diligence:* Ask for referrals from friends, family, and colleagues. Before you interview prospective applicants, have them complete an application, submit a resume, and provide references (and check their references). If possible have someone else sit in on the interview with you. Compile an employee handbook with job descriptions, office rules, and company policies.

From "Ten Tips for Hiring Employees for Your Home-Based Business" www.allbusiness.com