

BUSINESS USE OF HOME

I. WHAT'S NEW (THREE RECENT COURT CASES)

- A. **LIMITATIONS ON DEDUCTIONS FOR HOME OFFICE USE APPLY TO RENTERS-** A couple's deductions for the business use of their rented apartment are limited to the amount of gross income derived from the business use of the home for the tax year minus deductions that are allowable regardless of business use. Visin v. Commissioner, T.C. Memo. 2003-246 (8/18/03). The Tax Court held that Michael and Natalie's deductions for the business use of their apartment are subject to the limitations in Code Section 280A(c)(5). Code Section 280A(c)(5), the court explained, limits a taxpayer's deductions for the business use of an apartment to the amount by which the gross income generated from the business activity conducted in the apartment exceeds the deductions for expenses attributable to that activity that are not allocable to the business use of the apartment itself. According to the court, home office deductions are not allowed to the extent that they create or increase a net loss from the business activity to which they relate. The court found that the legislative history of Code Section 280A(c)(5) confirms that rule.
- B. **TV AND MOVIE SCRIPT WRITER MAY TAKE HOME OFFICE DEDUCTION** A taxpayer who wrote TV and movie scripts met the exclusive use test with respect to the office portions of his personal residences and was allowed take a home office deduction. Radnitz v. Commissioner, T.C. Summary 2003-29 (03/26/03). The relationship of Irwin Radnitz with the film and television industry for whom his writings were created and sold was that of an employee and was not an independent contractor relationship. Accordingly, the moneys Irwin received for his work products were reflected on Forms W-2, Wage and Tax Statement. The Tax Court allowed the home office deductions. According to the court, Irwin's use of home offices satisfied the tests of Code Section 280A(c)(1). First, Irwin met the exclusive use test with respect to the office portions of the personal residences. He allowed no personal use of the space that was used in the home as his office. Second, the offices were used on a regular basis, and Irwin worked full time as a writer. Third, the offices represented Irwin's principal place of business. The court noted that, since Irwin was an employee, Code Section 280A further requires that the home office space must be for the convenience of the employer. The court concluded that Irwin met that test. Irwin, the court stated, was a speculative writer who was on his own in creating the work that he sold or later hoped to sell. He was never provided with office space by his employers. In such a situation, the court stated, the home or self-funded office can only be said to be for the employer's convenience.
- C. **HANDYMAN'S MOBILE HOME IS NOT PRINCIPAL PLACE OF BUSINESS** A taxpayer's mobile home was not his "principal place of business" and, thus, he was not entitled to a home office deduction for expenses relating to his work as a handyman for three different businesses. White v. Commissioner, T.C. Summary 2003-18 (3112103). He primarily used one room of his mobile home as a home office. In this room, Joe had a computer, telephone, filing cabinet, desk, and chairs, and outside his home, he had a shed in which he stored his equipment. The Tax Court held that the Whites were not entitled to a deduction for their

home office related expenses. The court explained that when a taxpayer's business is conducted in part in the taxpayer's residence and in part at another location, the two factors that are important in determining whether the home office qualifies under Code Section 280A(c)(1)(A) as the taxpayer's "principal residence" include: (1) the relative importance of the functions or activities performed at each business location; and (2) the amount of time spent at each location. According to the court, none of Joe's services were performed at his home. Although he received orders for his services at home, the court noted, the most important parts of his activities were performed away from his home at the business locations of his client. In addition, the court determined that there was no evidence that the White's home was the situs of management or administrative activity related to his activity.

II. TESTS FOR DEDUCTIBILITY (SECTION 280A)

- A. The space is used in a trade or business on a regular, continuing basis.
- B. There can be no personal use (other than de minimis personal use) of the home office portion of the residence at any time during the taxable year.
- C. The taxpayer can deduct expenses for a separate freestanding structure, such as a studio, garage, or barn.
- D. A place to meet with patients, clients or customers.
- E. Principal place of Business
- F. Business use by an employee must be for the convenience of his/her employer

III. DEFINITIONS, EXCEPTIONS AND EXAMPLES

- A. Regular and continuing basis
 - 1. To store inventory for a wholesale or retail sales business
 - 2. To provide day care services
 - 3. As the principal place of business for any trade or business
- B. Exclusive Use can be a portion of a room as long as the taxpayer can prove a particular portion was used exclusively.
- C. Exceptions to Exclusive Use
 - 1. For the storage of inventory, if:
 - a) The inventory is kept for use in the taxpayer's business of selling products at wholesale or retail;
 - b) The residence is the only fixed location of the taxpayer's trade or business; and,
 - c) The space is separately identifiable (a portion of a room regularly used is acceptable):

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EXAMPLE OF STORAGE OF INVENTORY: Olive Oyl's home is the sole fixed location of her business of selling soaps and fragrances at retail. She regularly uses her basement for inventory storage, and occasionally for personal purposes. The expenses for the storage space are deductible even though part of the basement is not used exclusively for business

- d) Because the space must be used to store inventory, the cost of storage space for books, files, or equipment cannot be deducted unless the taxpayer qualifies under one of the other tests.
- e) The Small Business Job Protection Act of 1995 added an additional exception to the exclusive use requirement by including "product samples" eligible for the deduction so that taxpayers need not attempt to distinguish between inventory and product samples.

D. Separate Structure

- 1. The taxpayer can deduct expenses for a separate freestanding structure, such as a studio, garage, or barn if the taxpayer uses the structure exclusively and regularly in his/her business.
- 2. The structure does not have to be the taxpayer's principal place of business or the place the taxpayer meets patients, clients, or customers

EXAMPLES OF SEPARATE STRUCTURE: Lucky operates an herb shop in town. He grows the plants for his shop in a greenhouse behind his residence. Since the greenhouse is used exclusively and regularly in his business, he can deduct the expenses for its use subject to the deduction limit.

Miter Saw sets up a home office for his construction business in an unattached garage next to his home. He works there on evenings and weekends. Miter does most of his work at the construction location, and he never sees customers in his home office. Nonetheless, if he uses his home office exclusively for business, he can deduct his home office expenses.

E. A place to meet with patients, clients or customers

- 1. The patients, clients, or customers are physically present on the premises.

EXAMPLE: Joe Credit, an accountant, works three days a week in his office downtown. The office downtown is his principal business location. Two days a week, he works in an office in his home in a room he uses exclusively for business. He meets with his clients in the home office on a regular basis. His home office qualified for a business deduction because it is a place where he meets clients in the normal course of his business.

- 2. Conversations with the taxpayer by telephone do not constitute use of the premises by patients, clients, or customers.

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3. The use of the dwelling unit by patients, clients, or customers must be substantial and integral to the conduct of the taxpayer's business. Occasional meetings are insufficient

EXAMPLE OF OCCASIONAL MEETINGS: In *Cally v. Comm* 45 TCM 1312 (1983) a doctor was disallowed the deduction because he only saw patients when he was at home and a need arose.

F. Principal place of Business

1. A Taxpayer is deemed to have a principal place of business for each trade or business in which the taxpayer engages.
2. When a taxpayer engages in a single trade or business at more than one location, the principal place of business is determined in light of all the facts and circumstances (Prop. Reg. 1.280A-2(b)(3)).
3. The Supreme Court (*Soliman v. Corn*) [*Commissioner v. Soliman*, 506 U.S. 168 (1993)] held that determining the principal place of business is a subjective process that must be made on the facts of each case by comparing two primary factors:
 - a) The relative importance of the business activities performed at each location; and
 - b) The time spent working at each place.
4. Relative importance of business activities performed at each location was based on:
 - a) Identifying those activities most important to the business.
 - b) Determining the place where the taxpayer performs income-generating tasks.
5. TRA 97 expands the definition of "Principal place of business" effectively overturning the Supreme Court's decision in *Soliman*. TRA 97 still retains all other criteria previously mentioned relating to home office deductions (e.g., regular and exclusive use, storage, a place to meet patients, clients, or customers).
6. A home office also qualifies as a "principal place of business" if:
 - a) The office is used by the taxpayer on an exclusive or regular basis for the administrative or management activities of any trade or business of the taxpayer; and
 - b) There is no fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

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- c) Thus, a home office deduction is allowed if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer. The taxpayer must not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (e.g., billing activities) is performed by others at other locations,
- d) The fact that a taxpayer also carried out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, will not affect the taxpayer's ability to claim a home office deduction under the provision.
- e) If a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still is eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial. (For example, the taxpayer may occasionally do minimal paperwork at another fixed location of the business.)
- f) A taxpayer's eligibility to claim a home office deduction under the provision will not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home. (E.g., The taxpayer may meet with, or provide services to customers, clients, or patients at a fixed location of the business away from home.)
- g) Even if an office away from home is available to a taxpayer, but he chooses to perform substantial administrative or management activities at home, then the second part of the test will be satisfied.
- h) The law affects home office deductions for many small business owners, including:
 - (1) Doctors and nurses whose job performance primarily occurs in the hospital;
 - (2) Sales people where most of their time is spent at customer's offices;
 - (3) Authors and writers where most of their time consists or research, meeting with their publishers, and other promotional events outside of their home office;
 - (4) Contractors, painters, plumbers, and similar trades people who spend most of their time at the job sites

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G. Convenience of Employer test

1. Generally, convenience of the employer means a business necessity. Use of the home office is a condition of employment. The employee needs a place to work, but the employer does not so provide.
2. Usage for purely personal convenience is not sufficient.
3. The "Convenience of the employer" test for employees remains unchanged by the new law (i.e., the new law will not help employees who choose to work at home where their employer makes space available to them somewhere else).

IV. NO DEDUCTION FOR RENTAL TO EMPLOYERS

- A.** No deductions under Section 280A are allowed for expenses attributable to rent received by an employee for a portion of his/her home rented to his/her employer, if the employee uses the rented portion to perform services as an employee of the employer. This also applies to independent contractors. (Section 280A (C)(6)).

EXAMPLE OF NO HOME OFFICE DEDUCTION: Big Head is a salaried employee and the owner of Brain Research Inc. (BRI). BRI rents a portion of Big's home as its sole place of business. Big may not deduct any of the business expenses attributable to the rental of a portion of the home to BRI. (PLR 8824026).

EXAMPLE OF NO DEDUCTION FOR RENTAL TO CORPORATION: Don Juan owns a building with his home on the second floor and a retail store on the ground floor that he leases to his corporation that employs him. No trade or business deductions are allowed to Don Juan for the portion of the building rented to the corporation (PLR 8747007).

- B.** Under such lease or rental arrangement, the taxpayer may deduct those expenses allowable in the absence of business use.

EXAMPLE: Don Juan may deduct the interest, property taxes, and casualty losses relating to the retail store as a Schedule E expense.

- C.** Possible methods for avoiding Section 280A (C)(6) disallowance:
1. Employee owns home office, but performs no duties as an employee in the home office.
 2. Employee business expense reimbursement rather than rental arrangement (but the IRS will take a position that this is a disguised rental).
 3. Employee's spouse owns the house as the separate legal owner

V. COMPUTING THE BUSINESS DEDUCTION

- A.** Divide the area used for business by the total area in the home to determine the pro rata share of rent, utilities, etc.

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- B. Depreciation is based upon the lower of the adjusted basis of fair market value at the time business usage starts.
- C. When deductions are allowed under the above rules, all expenses pertaining to the residence must be allocated between the business use and the personal use portions of the residence divided into three categories:
1. **Unrelated Expenses:** Unrelated expenses are those that benefit only the parts of the taxpayer's residence that are not used for **business**, such as expenses for repairs to personal areas of the residence and lawn care and are not deductible as home office expenses.
 2. **Direct Expenses:** Direct expenses are expenses that benefit only the **business** part of the taxpayer's home, such as, painting or repairs made to the specific area or room that is used for business, are **deductible**, subject to the gross income limitations; in the case of a day-care facility, however, such expenses may be only partially deductible.
 3. **Indirect Expenses:** Indirect expenses are those that benefit **both** the **business** and personal use portions of the taxpayer's residence and are deductible subject to the gross income limitation.
 - a) The following are examples of indirect expenses that are deductible whether or not the residence is used for business purposes:
 - (1) Real estate taxes;
 - (2) Deductible mortgage interest ;
 - (3) Casualty losses.
 - b) The following are examples of indirect expenses that are deductible (subject to the allocation rules and the gross income limitation) only if the residence is used for business purposes:
 - (1) Rent;
 - (2) Utilities and services (e.g., electricity, gas, trash removal, and cleaning services, but not telephone service);
 - (3) Insurance;
 - (4) Repairs (e.g., patching walls and floors, painting, wallpapering, repairing roofs and gutters, and mending leaks);
 - (5) Security system;
 - (6) Telephone costs (IRC 262(b)).
 - (a) The basic line costs for the first telephone are non deductible personal costs.
 - (b) Long distance business charges are deductible.
 - (c) Deduct business portion of additional line costs and rental equipment charges.

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VI. DEDUCTION LIMITATION

- A. Deductions are limited to the gross income from the business use of the home office.
- B. Deductions in excess of the current year's limitation may be carried forward. Deductions carried to later years retain their character

VII. HOME OFFICE DEDUCTION AND SALE OF RESIDENCE

- A. On December 24, 2002, the IRS provided Taxpayers with an unexpected holiday present as outlined in IRR 1.121-1(e)(1). Simply stated, a taxpayer may be able to exclude gain from the sale of a principal residence he has used for business related purposes.
- B. If both the residential and non-residential portions of the principal residence are within the same dwelling unit, no allocation of the gain from the sale or exchange of the home is required. The IRC 121 exclusion does not, however, apply to the gain that is attributable to post May 6, 1997 depreciation adjustments, (i.e., the unrecaptured Section 1250 gain). Depreciation recapture only applies to depreciation claimed for which a tax benefit was derived. If the deduction limitation caused the depreciation to be suspended and carried forward, the sale of the residence would not trigger taxability to the amount carried forward an unused at the date of sale.