

FRANZEN & FRANZEN, LLP

CERTIFIED PUBLIC ACCOUNTANTS

February 18, 2013 – Home Office Deduction – Introducing a Simplified Option

The home office deduction rules are among the most complex in the Tax Code and are strictly enforced by the IRS. On January 15, 2013, the IRS announced a new simplified option (also known as a safe harbor method) to calculate the home office deduction. The simplified option, at this time, is capped at \$1,500 per year based on \$5 a square foot up to 300 square feet. It is important to weigh the benefits of using the new simplified option against computing the home office deduction under the regular Tax Code rules.

Regular rules

Individuals who use part of their personal residences for business may be able to deduct expenses for the business use of their home. This is known as the home office deduction. The rules frequently trip-up taxpayers because of their complexity. This letter is intended to present a general overview of the home office deduction. Your situation may be different depending on many factors.

In a nutshell, home office expenses may be deductible if part of the home is used regularly and exclusively as (1) a principal place of business for any trade or business of the taxpayer or (2) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business. In the case of employees, their use of their home must be for the convenience of their employer. Taxpayers may also be able to deduct expenses for a separate free-standing structure, such as a studio or garage if they use it exclusively and regularly for their business. There are also special rules for use of a part of a home as a daycare facility for children, individuals age 65 and older, or individuals who are physically or mentally challenged.

Exclusive use means just that. To qualify under the exclusive use test, a taxpayer must use a specific part of his or her home only for his or her business. A taxpayer does not meet the requirements of the exclusive use test if he or she uses the part of the home both for business and for personal purposes. Of course, there are exceptions. One exception is for taxpayers that use part of their homes as daycare facilities.

Taxpayers who qualify to deduct expenses for the business use of their home must divide the expenses of operating their home between personal and business use. Among the type of expenses that may be taken into account are the costs of insurance, utilities, repairs, and depreciation. Taxpayers who own their homes and qualify to deduct expenses for its business use may be able to claim a depreciation deduction. Depreciation is an allowance for the wear and tear on the part of the home used for business and is among the more complex calculations for the home office deduction.

Generally, deductions for a home office are based on the percentage of the taxpayer's home devoted to business use. If an individual uses one or two rooms or merely part of a room, the taxpayer must calculate the percentage of the home devoted to the business. For example, if the taxpayer's home is 1,200 feet and she uses one room (which is 240 square feet) for business activities, the business percentage use of the home is 20 percent (240 square feet divided by 1,200 square feet).

Taxpayers claiming the home office deduction file Form 8829, Expenses for Business Use of Your Home, with their individual income tax returns. According to the IRS, 3.4 million taxpayers claimed the home office deduction in 2010.

New Simplified Option

The new simplified option is intended to remove some of the complexity from the calculating the home office deduction. According to the IRS, the new simplified method will assist many small businesses in reducing the administrative, recordkeeping and compliance burdens now associated with taking a home-office deduction. It is an alternative to the calculation and allocation of actual expenses otherwise required for the home office deduction. Taxpayers using the simplified option, the IRS explained, must continue to satisfy all of the requirements for the home office deduction (such as exclusive use and the other criteria discussed above).

A taxpayer using the simplified option will calculate the amount of allowable deductible expenses for business use of a home for the tax year by multiplying the allowable square footage by the prescribed rate. The allowable square footage is the portion of the home used in a qualified business use of the home, but not to exceed 300 feet. The prescribed rate is \$5.00. Effectively, the simplified option provides a maximum deduction of \$1,500 (300 square feet multiplied by \$5.00). The IRS indicated that it may update the prescribed rate from time to time. Rules for use during only a portion of the year are also included. As with the regular method, the amount of the deduction cannot exceed the net income otherwise derived from the business use of the home.

The IRS has imposed some additional limits on the new simplified option. For example, taxpayers cannot also depreciate the portion of their home used in a business. The simplified option is not available to an employee with a home office if he or she is reimbursed for expenses of working out of the home office. Additional restrictions also apply. As a benefit, however, a taxpayer using the simplified option generally may take full itemized deductions for mortgage interest and property taxes, without any proration to account for a home office.

Taxpayers may elect to use the simplified option in one year and actual expenses in a subsequent year. However, once an election is made on the return filed for the tax year, it cannot be changed. The IRS indicated that taxpayers using the simplified option will not file Form 8829 but a different, as of yet, undisclosed form, which the IRS predicted will be less detailed than Form 8829.

Planning Considerations

The simplified option is optional. Some taxpayers may find it valuable because of its intended ease of use but it is not a “one-size-fits-all” substitute to the regular rules. The simplified option will be available with 2013 tax-year returns; it is not available for 2012 returns. The delayed effective date gives taxpayers time to explore the rules of the simplified option and compare them against the regular rules. Our office can assist you in evaluating the new simplified option. Please contact our office for more information about the home office deduction.