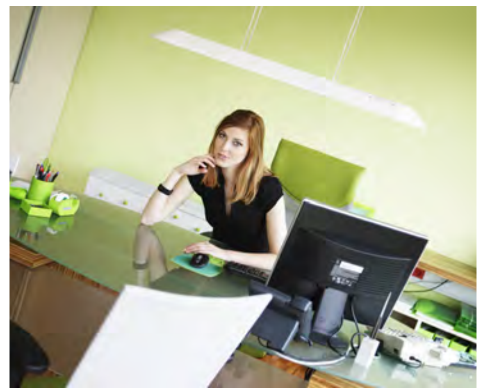
How to MAXIMIZE HOME OFFICE Deductions





"Increase Your Bottom Line When You Work At Home"

- An excerpt of Sandy Botkin's "Tax Strategies for Business Professionals" Workbook

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6 Increase Your Bottom Line When You Work At Home

Strategy 1: Depreciate assets to the extent used in business when you fail to qualify for the home office deduction.

Example: You work in an office at your home, but do not qualify for the home office deduction because the office is not used exclusively for business. Your work adds up to 80% of the use.

Result: You may depreciate the assets used 80% for business.[1]

Convert to Business Use: If you purchased the desk, file cabinet, and chair three years ago, you must convert the assets to business use under the lower of cost or market rule.[2]

Example: You have a desk you purchased three years ago. It cost you $500. It has a fair market value of $550. You depreciate 80% of the $500 because it is lower than $550.

Records: Keep records (like auto use records) of both business and personal use for 90 days.[3]

Strategy 2: Expense purchased home office assets to speed up deductions.

Special Expense Rule: Congress allows you to deduct immediately, rather than depreciate, up to $139,000 worth of business assets that you purchase during 2012.[4] The key word is "purchase." The assets may be new or used. This is allowed if your total asset purchases are less than $$560,000 in 2012.

Notes

Limitation: In order to expense the asset, the asset must be used at lease 50% for business. In addition, you can not use the tax expense election if it will create a loss.

Example: You buy a new $1,200 rug and spend $3,000 on a used photocopier. Rather than depreciate the assets over 5 years or more, you may expense the entire $4,200 this year.

Qualifying assets: Any asset that would have qualified for the old investment tax credit is eligible for the special asset expensing break. All home office depreciable equipment meets this test.

Recapture: If you expense an asset and then your business use drops to 50% or less, you must recalculate the original expense amount as if straight line depreciation was claimed and report the difference as taxable income.[5]

Expensive Purchases: If the newly purchased assets costs $239,000, you can expense the first $139,000 and depreciate the rest.

Hot Tip: If you are going to buy more than the $139,000 expense limit, but less than $560,000, consider buying $139,000 worth of equipment in 2012 and the rest in 2013. This way you can deduct $139,000 in 2012[6] and the rest of your equipment in 2013 instead of depreciating the difference over 5-7 years.

50% Bonus Depreciation: Under the new Small Business Jobs Act, for most tangible <u>new</u> equipment purchased in 2012, you can now deduct either 50% of the business use in the year you buy the equipment or take an election to write off up to $139,000 worth of equipment.

Example: Mark owns a farm and purchases $239,000 worth of <u>new</u> equipment in 2012. He can elect to deduct $139,000 and take 50% bonus depreciation on the remaining $100,000.

Strategy 3: Qualify for the home office deduction. The home office deduction could put from $10,000 to $30,000 after tax dollars in your pocket during the next five years. See the calculation of Snyder's savings on page on left.

The Home Office Rules

The Law: The Internal Revenue Code states that a home office deduction is available on to the extent that portion of the dwelling unit is used exclusively and on a regular basis as:[7]

- The principal place of business for any trade or business of the taxpayer
- A place of business that is used by patients, clients or customers in meeting or dealing with the taxpayer in the normal course of his/her trade or business , or
- In the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayers trade or business.

Notes

How Snyder Benefits From The Home Office Deduction

Facts: Snyder files a joint tax return with his wife. The Snyders earn $150,000 in taxable income. That puts them in the 31% federal and 10% state income tax bracket. Mrs. Snyder earns $78,000 from her job as an employee in town. Mr. Snyder works out of his home and earns net taxable income of $72,000, which is reported in Schedule C of their Form 1040.

First Year Tax Refund

	Total	Home Office Percentage	Home Office Deduction	Tax Benefit Rate	Tax Refund
Mortgage interest	$10,401	15.84%	$1,648	13.02%	$215
Real estate taxes	947	15.84%	150	13.02%[1]	20
Utilities	1,704	15.84%	270	54.02%[2]	146
Homeowner's insurance	310	15.84%	49	54.02%	26
General repairs	600	15.84%	95	54.02%	51
Pest control	400	15.84%	63	54.02%	34
Repairs to office	200	100%	200	54.02%	108
Depreciation-furniture	1,886	100%	1,886	54.02%	1,019
Depreciation-home	2,545	15.84%	403	54.02%	218
Snyder's cash-in-pocket from home office deduction					$1,837

Economic Results

Cash from home office deduction	$1,837
Cash from extra business mileage	582[3]
Total first year cash	2,419
6% annuity due factor for 5 years	x 5.9753
Net cash after 5 years	$14,454

[1]Self-Employment tax rate

[2]13.02 self-employment tax rate plus 31% federal tax rate plus 10% state tax rate

[3]Snyder's home business allows him to reduce his personal mileage and increase his business auto expense by $1,077. Thus, $582 is refunded by the tax collectors ($1,077 x 54.02%).

In addition, in the case of an employee, the home office deduction is allowed only if the exclusive use is for the convenience of the employer.[8]

Method one is to do your most important tasks at home: The Supreme Court decision in Soliman[9] interpreted what constitutes a "principal place of business" for purposes of the home office deduction. The courts defined the "principal place" as where you perform your most important tasks of the business such as where you make the cash register ring or where you see clients or patients.

Method two is the time test: If there is no one spot from which you perform your most important tasks or is hard to tell where you perform your most important tasks, the Court adopted a "time test," which asks whether you performed over one-half your working hours in your home office.

Soliman's Office: Dr. Soliman was an anesthesiologist who performed services at three hospitals for 30 to 35 hours per week. He was provided with no office space at the hospitals. He used a home office 10-15 hours per week to:

- Have telephone conversations with patients and other medical doctors.
- Conduct his research and design treatments for his new and existing patients.
- Write up and maintain patient logs and medical records
- Study for any continuing education in his home office.

Dr. Soliman had no other office in which these were performed.

Dreadful Decision: The court ruled that Soliman gets no deduction for an office in his home despite the following facts:

- Soliman's home was integral and essential to his business.
- The office was used exclusively for business on a regular basis.

The Soliman Quiz: You should either regularly see clients or customers and close sales in your home office OR spend more than one-half your total work time working in your home office.

If you answered "no" to the above questions, your home office deduction could be lost under the Supreme Court decision. As you can see, this was a bad decision for most businesses.

Notes

Method 3 is to use the Congressional exception to Soliman: Starting in 1999, Congress liberalized the home office rules making it much easier for many people to claim a home office deduction. They did this by carving an exception to Soliman. Now your home office qualifies as a "principal place of business" for the home office deduction if:

1. The office is used to conduct administrative or management activities for a trade or business, and
2. There is no other office where you conduct substantial administrative or management activities.[10]

Thus, if you do your logs, contact patients, or customers, listen to educational tapes, read business related materials and prepare bills for customers than you're rendering administrative activities.

Insignificant Services Elsewhere: The fact that you some administrative services elsewhere won't count against you if these services are not substantial. Thus, if you occasionally do some paperwork elsewhere, this won't disqualify you from the home office deduction. Keeping a good log of where you work is vital if you have more than one office.[11] In fact, even if an office is provided you, you can still opt to work out of your home and perform all of your administrative activities out of your home.[12]

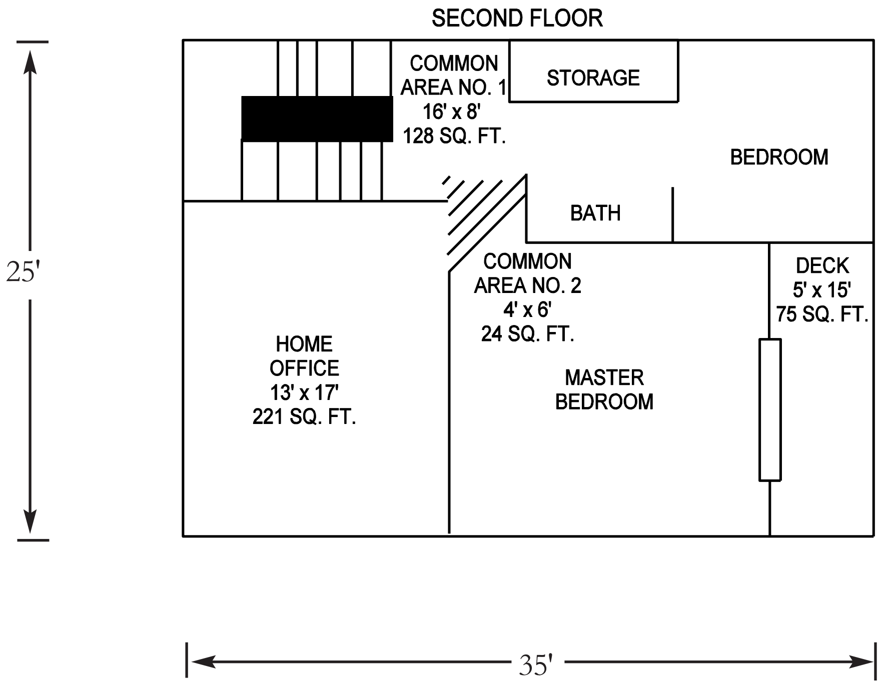
Example: John, a self-employed plumber, spends most of his time in homes repairing and installing plumbing. He has an office at home that he uses exclusively and regularly for his administrative and management activities such as billing customers, making appointments, and ordering supplies. His home qualifies as a principal office for the home office deduction.[13]

Example: Margie is a realtor. She is provided an office by her broker but opts to perform almost all of her administrative activities out of her home. She does all cold calling and mailings from her home. She does her logs at home. She reads her continuing education at home and compares comparable price sheets from her home computer. She only goes into the office when she has phone duty, sales meetings, to turn in contracts, and to meet clients. Margie's home would qualify as a "principal place of business" for the home office deduction.

Winners: The clear winners are those that have a home based business such as network marketers and consultants as well as free-lance writers and free lance musicians who choose to work from their home. Anyone who works at home and performs most of their administrative activities for their business from their home in an exclusive portion of their home will be a winner!

Notes

Maximizing Home Office Square Footage



Three Choices:

1. Number of rooms office occupies, divided by total rooms in house.
2. Total square footage office occupies as a percentage of total square footage in house.
3. Net square footage applicable to office use.

Computation Of Net Square Footage:

Total square footage 25' x 35' x 2 floors		1,750
Deduct:		
Common areas:		
First floor entry and stairway	128	
Second floor stairway and landing	128	
Second floor common area	24	
Deck (not a living area)	75	355
Net square footage base		1395

Analysis Of Choices Based On:

1. Number of rooms 1/8 – 12.50%
2. Total square footage 221/1675 (1750 – 75 for deck) = 13.19%
3. Net square footage 221/1395 = 15.84%

Other Home Office Requirements

1. **Exclusive use:** The term "exclusive use" means just that.[14] No personal or other nonqualifying work activities may occur in your home office area.[15]

   Part of a Room: A portion of a room can qualify as a home office, but all business items must be located in the same contiguous area and there should be some physical separation of the business area from the personal area.[16] A movable partition (also deductible) can be used to define the home office area.

2. **Regular use:** IRS code does not define regular use. However, the courts indicate that using your home office 3 to 4 times for a total of 10 to 12 hours a week should be regular.[17]

   Principal Place of Business: There are three ways in which your home qualifies as a principal place of business.

Strategy 4: Use the meet and greet test to qualify for the home office deduction.

Exception to general rule: If you do not use your home office as your principal place of business, another way to qualify for the deduction is to use the home office as a place to meet or deal with clients, patients, and prospects in the normal course of your business.[18] This exception applies only if the use of the home office by your clientele is substantial and integral to conducting your business.[19] Occasional meetings are insufficient to make this exception applicable.[20]

Physical presence required: The key words for this exception are "meet or deal" with clients, patients, or customers. This demands a physical presence of patients or customers, not just a telephone presence, no matter how extensive or frequent the telephone conversations.[21]

Regular: The meeting and dealing must be on a regular basis.[22] How often is regular? How often must you meet with clients, customers, patients, or prospects for such meetings to constitute normal course of business? At a minimum, you must prove that such meetings are ordinary, usual occurrences in your business - not occasional, spur-of-the-moment, or last-minute accommodations to someone's schedule.[23] In other words, home office meetings must be integral to the way you conduct your business.

Strategy 5: Qualify for the home office deduction by using a separate structure in connection with your business.

You may qualify for a home office deduction if, in connection with your trade or business, you use a separate structure not attached to your dwelling unit. [24] The separate structure must be used exclusively and on a regular basis for business.[25] It need not be your principal place of business or a place where you deal with customers, clients, or patients.[26] Examples of structures that meet the separate structure requirements are an artist's studio, a florist's greenhouse, and a carpenter's workshop.

Strategy 6: Inventory and Product Samples.

A deduction is now allowed when used on a regular basis to either store inventory and/or product samples if you are in a business of selling products at retail or wholesale and if your residence is the sole fixed location for that business.[27]

Strategies That Build Bigger Tax Benefits

Strategy 7: Avoid taxable income when you sell your home.

Universal exclusion rule overview: If you sell your home after May 6, 1997, a fabulous new universal exclusion applies to you at any age. You now can avoid up to $500,000 of profit (if married filing jointly), or $250,000 (if single).[28]

Prior Depreciation Taken: If you have taken any depreciation on your home after May 6, 1997 either from a home office deduction or by treating the home as a rental property, you must separate the gain on the sale of the old house into two parts: depreciation taken and other gains.

Example: John and Mary claimed a home office deduction for their network marketing business. If the house has appreciated to $100,000 but they got $10,000 of depreciation, John and Mary will have to pay tax on the $10,000 at their normal income tax rates.[29]

Exclusion rule: Although the normal exclusion amount is $250,000, married couples get to exclude up to $500,000 of gain if:[30]

- They file jointly, and
- Either spouse owned the house for two of the last five years, and
- Both spouses used the home as their principal residences for two out of the last five years, and
- Neither spouse has claimed the exclusion within the last two years.

The two year requirements as to ownership and use need not be the same two out of five years.[31]

If only one spouse meets these rules, you may utilize the $250,000 exclusion. This will also apply to newly married couples.

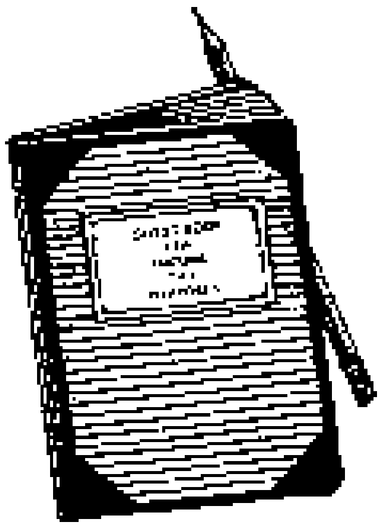
Single people will get the $250,000 exclusion if they individually meet the two year ownership and use rules and haven't used the exclusion within the past two years.

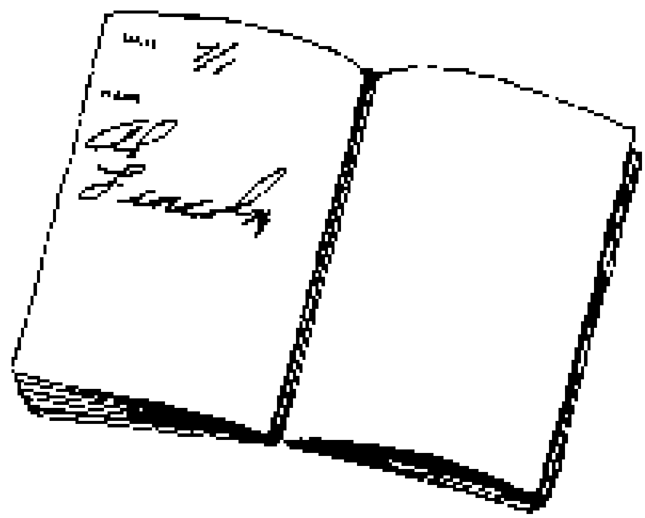
Observation: You can, therefore, use the exclusion every two years.

Exceptions for forced sales: Congress enacted some relief for you if you are required to sell your house before the two year period of occupancy expires or even if you have used the exclusion less than two years ago.

If you have a change in employment, health or other unforeseen circumstances (e.g. divorce, multiple births, job changes / job losses), then you may be entitled to a partial exclusion.[31]

Guest Book For Home Office





Work Activity Log For Typical Morning

1

MONTH *MAY*

DAY OF THE WEEK *S M T W TH F S*

DAILY APPOINTMENTS	BUSINESS	COMMUTE	PERSONAL
7:00AM			
8:00 Study HTSA Program HO			
9:00			
10:00 Prospect Calls			
11:00 AL Lincoln Contract			
12:00			
1:00PM			
2:00 Windy Wilson OO			
3:00			
4:00			
5:00			
6:00			
7:00			

HO=HOME OFFICE
OO=OTHER OFFICE

Example: Lori sells her house because she has a new job in another town. On the date of sale, she has owned her principal residence for 18 months. She has never excluded gain from another home sale. If she had lived there for two years, she would avoid up to $250,000 of gain. However, since she didn't meet the two year occupancy requirement because of a job change, she can exclude 18/24 of the $250,000 or $187,500.

Note: By not meeting the rules due to unforeseen circumstances, you still get a partial exclusion.

Strategies To Bullet-Proof And Retain Home Office Deductions

Strategy 8: Photograph the office.

You use a home office today, but will you use it tomorrow? There's no way to know for certain, so take a photograph of your office to prove that it actually existed. To prove when the office existed, establish the vintage of your photograph with a processing date. Most photofinishers print the processing date on the back of the photograph. Make sure your photograph is processed by such an establishment.

Strategy 9: Prove your home office space.

Keep blueprints of your home to prove the amount of space occupied by the home office. If blueprints are not available, make a drawing of your home showing the relationship of the home office's square footage to the total square footage of the home.

Strategy 10: Prominently display your home office phone number and address on business cards, stationary, and advertising.

You must be able to prove that you actually operated a business from your home. If economically feasible, install a separate business phone in your home. The business phone should be listed in the business's name in both the white and yellow pages. You should have business stationery with your home address on it. If you have two business addresses, they should have equal prominence on the stationery. Use your home address on your business cards. If two addresses appear, they should have equal prominence. Similarly, both phone numbers should have equal prominence.[32]

Strategy 11: Have your guests sign a guest log book when they visit your home office.

If you claim a home office deduction because you use the office in the normal course of business to meet and deal with clients, patients, and prospects, have your business visitors sign a guest book each time they come to your office. The guest book need not be formal, just a record that business contacts actually meet with you in your home office. Remember, the burden of proof is on you. If you claim use of your home office to see clients and customers, don't forget you must be able to prove that clients, patients, prospects, or colleagues were physically present in your home office.[33]

Strategy 12: Keep a time and work activity log.

A work activity log (really a meticulously annotated daily diary) offers an excellent supporting document to establish where you spend your work time. The work activity log does not need to be an elaborate document. You already have a daily diary. Simply use it as an activity log. If you are working at your home office, you could simply write "home office" (or some abbreviation) and note the time spent in the home office. Details indicating the specific type of work you are doing at home help immensely.

Strategy 13: Retain Receipts and Paid Invoices.

General rule: Canceled checks only prove that you paid the bill. You must support the canceled checks with receipts and invoices.

Expense types: When calculating your home office deduction you must consider two types of home expenses: (1) those that benefit the entire home and (2) those incurred solely as a result of the home office. You must keep receipts for both.

Entire home: You are allowed to deduct a portion of the expenses that benefit the entire home including utilities, general home maintenance, and homeowner's insurance.[34] At the end of the year, you allocate these expenses based on the business use percentage of your home.[35]

Office only: You are allowed to deduct all expenses that benefit only the home office.[36] Expenses benefiting only the home office include repairs to the home office area plus office supplies and other items purchased specifically for the home office area. There's nothing tricky about these expenses, but you must have receipts to support your expenditures.

Strategy 14: Deduct long-distance telephone charges.

Beginning in 1989, tax law allows no deduction for the first telephone into your personal residence, regardless of use.[37] Local charges are deductible only if you install a second phone in your home. Long-distance charges are deductible and should be documented.

Caution: Your home office deduction is limited to the net income from the business attributable to your home office.[38] Thus, if your net income equals $2,000 after deductions, your home office deduction would be limited to the $2,000. However, any excess can be carried forward forever.

Notes

Work At Home Summary

How you benefit when you work at home

1. Depreciate business assets to extent of business use
2. Expense purchases of business assets
3. Qualify for the home office deduction

Strategies to qualify for the home office deduction

4. Meet and greet in normal business
5. Separate structure in connection with business
6. Store inventory and product samples

Strategy to build bigger tax benefits

7. Eliminate office in year of sale to avoid taxable income

Strategies to audit proof and retain home office deductions

8. Photograph the office
9. Prove space used for home office
10. Display home office phone number and address where appropriate
11. Have business guest register in log book
12. Keep a record of your home office time in your diary book
13. Retain receipts and paid invoices
14. Deduct business-related long-distance telephone charges

Notes

6. Increase Your Bottom Line When You Work At Home

1. E.g., IRC § 280F; Sherri A. Mulne, TC Memo 1996-320
2. Reg. 1.167(g)-1.
3. Temp. Reg. § 1.274-5t(c).
4. IRC § 179 as amended by Small Busines Jobs Act 2010.
5. IRC § 280F(d)(1).
6. Section 1.168(k) 1T(b)(3)(v) of the Income Tax Regulations.
7. IRC § 280A(c)(1).
8. IRC § 280A(c).
9. Commissioner of Internal Revenue vs. Soliman, No. 91-998, Supreme Court of the U.S. (January 1993)
10. Taxpayer Relief Act (TRA) page 932, which amends section 280(A)(c)(1) of the IRC.
11. Research Institute of America Report on Taxpayer Relief Act of 1997/ (HR 2014), Page 460.
12. H. Report 105-148 (PL 105-34), page 407.
13. IRS Publication 587
14. See Gomez V. Commissioner, 41 T.C.M. 585 (1980); Prop. Reg. § 1.280A-2(g).
15. A.W. Hamacher, 94 TC_, No. 21, CCH Dec. 46,444 (1990).
16. Gomez v. Commissioner, 41 T.C.M. 585 (1980); Prop. Reg. § 1.280A-2(g). See also Jack C.C. Huang; TC Summary Opinion 2002-93 (7/18/02).
17. See Green v. Commissioner, 78 T.C. 428 (1982) (2 1/4 hours a night, 5 nights a week), rev'd on another issue, 83-1 USTC q9387 (9th Cir. 1983).
18. IRC § 280A(c)(1)(B) and Prop. Treas. Reg. § 1.280A-2(c).
19. Prop. Treas. Reg. § 1.280A-2(c).
20. Ibid.
21. Green v. Commissioner, 707 F.2d 404, 83-1 U.S.T.C. 9387 (9th Cir. 1983); Frankel v. Commissioner, 82 T.C. 318 (1984); Prop. Treas. Reg. § 1.280A-2(c).
22. Frankel, supra.
23. Jackson, supra.
24. IRC § 280A(c)(1)(C) and Prop. Treas. Reg. § 1.280A-2(d).
25. Ibid.
26. IRC § 280A(c)(1)(C); Scott v. Commissioner, 84TC 683 (1985). Scott involved two issues: the first concerned the "separate structure" exception and the second concerned application of the gross income limitation. Congress nullified the Scott case on the court's interpretation of gross income. The court's decision on the separate structure is still valid.
27. § 280A(c)(1)(C).
28. Taxpayer Relief Act of 1997, § 312 also see § 121(a) of the Internal Revenue Code.
29. Taxpayer Relief Act of 1997, § 311 also see § 121(d)(6) of the Internal Revenue Code.
30. Taxpayer Relief Act of 1997, § 312 also see § 121(b)(2)B & 121(b)(2)(c) of the Internal Revenue Code.

31. IBID and Rev. Rul. 80.172, 1982 CB 56.
32. Jackson vs. Comm, 76TC 696 (1981); Heuer vs. Comm, 32TC 947 (1959).
33. Prop. Treas. Reg. § 1.280A-2(c).
34. Prop. Treas. Reg. § 1.280A-2(i)(5)(ii).
35. Prop. Treas. Reg. § 1.280A-2(i).
36. Prop. Treas. Reg. § 1.280A-2(i)(5)(ii).
37. P.L. 100-647 § 5073, enacting new IRC § 262(b).
38. Section 280A(c)(5).

Notes