

## **To Our Clients and Friends:**

With increasing traffic gridlock in many areas and continued corporate downsizing even amid a booming economy, the lure of telecommuting or starting a home-based business has grown dramatically within the last few years. All of this business activity outside of a traditional office setting invariably causes some to ask: What does working at home do for me taxwise?

As we'll see, the answer is generally favorable for those who are self-employed and working out of a home office. Unfortunately, if you're working for someone else while using your home office, the tax deductions are tougher to come by.

Let's start with the good news for self-employed individuals, and then we'll see what's available for telecommuting employees.

### **Tax Benefits of a Home-Based Business**

The home office deduction. Deducting the costs of using a portion of your home for business purposes can be one of the biggest tax benefits of having a home-based business. After all, the space is there anyway, so why not let Uncle Sam pick up part of the costs of maintaining it.

To claim a home office deduction, a portion of your home (which can be one or more rooms or even just a separately identifiable area in a room) must be used regularly and exclusively as a principal place of business or as a place to meet or deal with clients and customers in the normal course of business. A separate structure from the residence (such as a barn or detached garage) can also qualify if used in connection with a business.

The term "regularly" means you must use a portion of your home on a continuing basis, while the term "exclusively" means the space is used only for business purposes. With two exceptions, personal use of the space, even after business hours, will make the costs of maintaining the office nondeductible. The two exceptions are for inventory storage (including product samples) and certain use as a daycare facility. Space used for either of these purposes can be used for personal purposes as well.

Because most people don't meet with clients or customers in their home office and also don't have their home office in a separate structure, the principal place of business test is normally the easiest path to a deduction. This is especially true starting this year because of a change Congress made in the definition of a principal place of business. Under the new rules, a home office is your principal place of business if it's where the most critical activities of your business take place or it's the only fixed location where you conduct substantial administrative or management activities for your business. Thus, anyone from a writer to a plumber or a doctor to a builder can potentially qualify his or her home office for deduction.

What's deductible? If you have a qualifying home office (i.e., one that satisfies the rules we just discussed), you can write off an allocable portion of the home's utilities, insurance, property taxes, mortgage interest, and depreciation. In addition, other costs of operating the home office such as supplies or furniture can either be expensed directly or written off through depreciation,

depending on the nature and the amount of the expense. However, with the exception of property taxes and mortgage interest (which are normally deductible even if you don't have a home office), these expenses are only allowed to the extent they don't reduce your business income below zero. The unused portion of any expenses limited under this rule can be carried over to the following year, subject to the same restriction.

The cost of a home-based computer and any related equipment designed to be placed under its control (such as a printer or scanner) is also deductible if used for business purposes in a qualifying home office. In addition, even if not used in a qualifying office, the business portion of a home-based computer is still deductible—subject to a requirement to document the business use.

The basic charge (including taxes) for the first telephone line into a residence is a nondeductible personal expense. However, the cost of any business long distance calls made on that line plus the business portion of any additional lines into the residence is deductible as a business expense.

Deducting commuting expenses. The obvious advantage of working out of your home is that you don't have to commute to work. The not so obvious advantage of having a qualifying home office is that when you leave your home on business, the cost of the trip is deductible even if your destination is in the same metropolitan area where you live and work. In contrast, someone who doesn't have a qualifying home office is normally limited to deducting only the costs of traveling between multiple business stops within town. (In other words, their costs of traveling between their home and the first business stop and between the last businesses stop and back home again are typically a nondeductible commuting expense.) Thus, for taxpayers who make a lot of local trips from their home office base, their transportation expenses may yield a bigger deduction than the expenses they're able to write off because of the home office itself.

Potential trap when the house is sold. Taxpayers normally can exclude up to \$250,000 (\$500,000 for a married couple filing a joint return) of the gain on the sale of a property used as their principal residence for at least two of the five years prior to the sale. However, the exclusion doesn't apply to the extent of depreciation on the house since May 1997. Such depreciation is "recaptured" if the home is ever sold at a gain. In addition, the portion of the home used as an office is tested separately to see if it was used as a principal residence for the requisite two out of five years.

Although having to recapture the depreciation is not that big of a deal (because you've been able to use the government's tax money like an interest-free loan from when the depreciation was deducted until you have to pay it back), not qualifying for the \$250,000/\$500,000 exclusion on the entire house could be a problem. Thus, if you expect to sell your home at a substantial profit within the next few years, it might be helpful to avoid the home office deduction for at least two of the five years prior to the sale. The easiest way to do this, of course, is to simply use otherwise qualifying space in your home for personal purposes at least a portion of the time.

## **What's Available for Employees?**

The home office deduction. An employee can claim a deduction for a home office if the business use of the home is for the employer's convenience and the space is used exclusively and regularly for job-related activities. As a practical matter, it is difficult to pass these tests.

Employees who "telecommute" a few days a week (i.e., they work at home but access and share information using telephones, computers, fax machines, etc.) cannot deduct the cost of a home office unless the arrangement is for the employer's convenience. If the individual also has an office furnished by the employer, it is unlikely that working at home is for the employer's convenience.

However, some employers have adopted a system of sharing office space known as "hotelling." Employees must reserve time in a shared office space when they need it for specific tasks (such as meeting clients). When not using the employer's office space, the employee works at home. This arrangement may be for the employer's convenience if, for example, its purpose is to save the employer overhead costs. In this situation, the employee should be able to deduct the home office expenses (if the other requirements for the deduction are met). Unfortunately, it may be a hollow victory because such expenses are claimed as miscellaneous itemized deductions, which means they (along with other miscellaneous deductions) are only allowed to the extent they exceed 2% of the taxpayer's income.

Individuals who are employed full-time and who also operate a sideline business from their home may unexpectedly run into problems with the strict rules that apply to an employee's eligibility for a home office deduction.

Example: Doug is employed by a software company as a programmer. He occasionally brings work home for his own convenience and uses a room over his garage as an office. He also operates a sideline business designing Web pages and uses this same space on a regular basis for this business activity. However, because he occasionally performs work in the home office as an employee of the software company for his own convenience (not his employer's), no home office deduction is allowed for the sideline business.

Computer use. An employee can qualify to depreciate or expense the cost of a personally acquired computer used at home for business purposes. However, the use must be for the employer's convenience and required as a condition of employment. In addition, any allowable deduction is claimed as a miscellaneous itemized deduction. Thus, like the home office deduction, these standards are tough for an employee to satisfy.

Commuting costs. Employees who do not have a qualifying home office can deduct the cost of traveling from their residences to temporary work locations as long as they have a regular place of work outside of their home. However, the cost of traveling from their home to a regular work location is a nondeductible personal expense. In addition, because the cost of traveling to a temporary site is a miscellaneous itemized deduction, employees would be much better off if their employers reimbursed them for the expenses (and perhaps took the benefit of the reimbursement into account at the time of their next salary adjustment) rather than trying to claim the expense on their personal return.

## **Conclusion**

As you can see, claiming the costs of working out of your house can potentially yield a nice deduction if you're self-employed. However, for an employee the deduction is generally worthless.

If you have any questions about how the rules apply in your situation, please feel free to call us.

Best regards,

Carol Barsness, CPA