NEW HOME OFFICE DEDUCTION RULES

Starting on January 1, 1999, the home office deduction rules have been liberalized, thanks to the Taxpayer Relief Act of 1997 (the 1997 Tax Act). By these new rules, Congress intends to make the deduction more widely available, thereby lowering your income taxes. However, you might not want to thank the Congress yet. Legislators may have failed to consider that, due to other provisions of the 1997 Tax Act, under certain circumstances, taking the deduction could actually cause you to pay more income taxes. This article discusses how these new rules operate concerning home-based business owners. (The rules for employees who have a home office differ and are not covered by this article.)

Since 1976, the home office deduction has been available only if you operated your home-based business: (1) as your principal place of business or (2) exclusively and regularly in any one of these three ways: (a) as a place to meet or deal with patients, clients, or customers in the normal course of your business; (b) to store inventory for use in your wholesale or retail business; or (c) in a separate structure located on the same lot as your house, but not attached to your house (such as a garage).

Taxpayers who tried to satisfy the "principal place of business" provision were often unable to take the deduction if they conducted business at their home office and at one or more other locations. The classic example occurred in the case of a self-employed anesthesiologist who worked out of his house, but who also used a hospital operating room. The Supreme Court denied his home office deduction on the grounds that the hospital, not his home office, was his "principal" place of business.

The 1997 Tax Act eliminates the principal place of business test. Now, you should qualify for the home office deduction if you satisfy the following two requirements: (1) you use your home office exclusively and regularly for administrative or management activities, and (2) you have no other fixed location where you conduct substantial administrative or management activities.

The IRS has explained its interpretation of this new rule in Publication Number 587. For example, administrative or managerial activities include meeting, phoning, or billing customers, patients, or clients; keeping books and records; ordering supplies; setting up or conducting appointments; and forwarding orders or writing reports. Publications 587 also states that the following will not necessarily disqualify your home office deduction: (1) having employees or contractors perform administrative functions at other locations, such as hiring a billing or bookkeeping service; (2) conducting certain administrative or management functions at places that are not fixed locations, such as in a car or hotel room; and (3) using a home office even though you might have suitable space outside your home, such as shared office space provided by someone else.

Besides liberalizing the home office deduction, the 1997 Tax Act also changes the rules for recognizing gain from the sale of your house. (Gain is the sale price minus the amount that you originally paid for the house. If you make improvements to the house, you may be able to add the cost of those improvements to your original purchase price.) Previously, you would not pay tax on the gain if you used the sale proceeds to purchase a new house within two years of the sale. With the 1997 Tax Act, Congress is trying to lower taxes on the sale of a home. Now, if you are a single taxpayer, you may exclude up to $250,000 of gain from the sale of your home, provided it was your primary residence during at least two of the five years prior to the sale. Married taxpayers filing joint returns may exclude up to $500,000.

Congress enacts tax laws, but the IRS interprets those laws. Although the IRS has not yet issued definitive pronouncements, it appears that Congress overlooked certain circumstances whereby taking the home office deduction could actually cause you to pay more taxes when you sell your house. This might happen in two ways.

First, when calculating the gain on the sale of your home, the IRS may interpret the 1997 Tax Act so that you, in effect, must reduce the original purchase price based on the portion of your home that you used for your office. For example, if you used 10 percent of your home for your office and took a home office deduction, when you calculate the gain, you might be required to reduce your original purchase price by 10 percent. Reducing the amount of the original purchase price will increase the amount of gain, possibly pushing you over the $250,000/$500,000 exclusion. Of course, if you had a home office but never took the deduction, you would not be required to reduce the original purchase price.

Second, if you take a home office deduction for a period starting after May 6, 1997, the IRS may require you to pay income tax on a portion of the gain, again based on the portion of your home that you used for your office before you sold the house. For example, let’s assume that you used 10 percent of your home for your office, you took a home office deduction, and you sold your house for $250,000. The IRS might require you to pay income tax on $25,000. In other words, you might have to reduce your original sale price and pay an increased tax on a portion of the gain. Again, if you never took the home office deduction, you would not owe that tax.

Whether the expanded scope of the home office deduction actually benefits many home-based businesses remains to be seen. Before taking the deduction, you should compare the taxes that you will save through the deduction against the additional taxes you might pay upon the sale of your house. Whether the deduction will actually save or cost you money may depend on the length of time you remain in your home along with other factors, such as the rate at which the value of your home appreciates. As mentioned above, Congress may or may not deserve our thanks!